CLERK'S COPY.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 371

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

vs.

JOHN H. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 18, 1944
CERTIORARI GRANTED OCTOBER 16, 1944

No. 10478

United States
Circuit Court of Appeals
For the Ninth Circuit.

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the Tax Court of the United States

Rotary Colorprint, 590 Folsom St., San Francisco

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES:

For Taxpayer:
CLARENCE D. PHILLIPS, Esq.,

For Comm'r:
E. A. TONJES, Esq.,
R. C. WHITLEY, Esq.

Docket No. 110050.

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1942

Mar. 2—Petition received and filed. Taxpayer notified. Fee paid.

Mar. 2—Copy of petition served on General Counsel.

Apr. 15—Answer filed by General Counsel.

Apr. 15—Request for hearing in Portland, Oregon, filed by General Counsel.

Apr. 18—Notice issued placing proceeding on Portland, Oregon, calendar. Service of answer and request made.

Aug. 7—Hearing set Sept. 14, 1942, in Portland, Oregon.

1942

Sept. 17—Hearing had before Miss Harron on merits. Submitted. Briefs due 11-2-42. Replies 11-17-42.

Oct. 14—Transcript of hearing 9-17-42 filed.

Oct. 27—Brief filed by taxpayer.

Nov. 2—Motion for extension to Nov. 17, 1942, to file brief filed by General Counsel.

Nov. 3—Order extending time to Nov. 17, 1942, to file brief of respondent, and to Dec. 17, 1942, to file both reply briefs, entered.

Nov. 17—Brief filed by General Counsel, Served 11-18-42.

Nov. 18—Copy of brief served on General Counsel.

Dec. 14—Reply brief filed by taxpayer. 12-14-42 Copy served on General Counsel.

1943

Feb. 26—Memorandum Findings of fact and Opinion rendered. Harron, Judge. #13. Decision will be entered under Rule 50. 2-26-43 Copy served.

Mar. 18—Computation of deficiency filed by General Counsel.

Mar. 24—Hearing set April 7, 1943, on settlement.

Apr. 7—Hearing had before Judge Murdock on settlement under Rule 50. Respondent's computation not contested. Referred to Judge Harron for decision.

Apr. 7—Decision entered. Harron, Judge. Div. 13.

May 19—Petition for review by U. S. Circuit Court of Appeals 9th Circuit, filed by taxpayer.

1943

Jun. 9—Proof of service of filing petition for review filed by taxpayer.

Jun. 9—Statement of points to be relied upon, filed by taxpayer with proof of service thereon.

Jun. 9—Agreed designation of portions of record proceedings and evidence to be contained in record, filed [1*]

Before the United States Board of Tax Appeals

Docket No. 110050.

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named Petitioner hereby petitions for a redetermination of income tax liability for the calendar year ended December 31, 1938, and for the calendar year ended December 31, 1939, as determined by the Commissioner of Internal Revenue in his notice of deficiency dated January 31, 1942, and as a basis of this proceeding the Petitioner alleges as follows:

*Page numbering appearing at top of page of original certified Transcript of Record.

I.

That the Petitioner is an individual whose business address is 1233 American Bank Building, Portland, Oregon, and that the said Petitioner filed with the Collector of Internal Revenue, for the District of Oregon, at Portland, Oregon, his income tax returns for the calendar year 1938 and for the calendar year 1939.

II.

Notice of deficiency (a copy of which is hereto [2] attached and marked Exhibit A) was mailed to the Petitioner on January 31, 1942.

III.

The taxes in controversy are income taxes for the calendar year 1938 and the calendar year 1939; the deficiency asserted for the calendar year 1938 is the sum of $33,502.64, together with a penalty thereon of $1675.13; that the deficiency asserted for the calendar year 1939 is the sum of $29,444.39, together with a penalty thereon in the sum of $1472.22; that the total deficiency asserted for both years is the sum of $62,947.03, and the total penalty asserted is the sum of $3,147.35, and that all of said amounts are in controversy.

IV.

The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) In determining the taxable net income of the Petitioner for the calendar year 1938, the Commissioner erroneously included income in the amount of $81,021.60, which the Commissioner

claims the Petitioner received as income by reason of his purchase from Western Cooperage Company during the calendar year 1938 of voting trust certificates representing 33,759 shares of the Common [3] Capital Stock of Hawley Pulp and Paper Company. The Petitioner claims that the said $81,-021.60 was not income under the provisions of Section 22 (a) of the Revenue Act of 1938 or under the provisions of Regulations 101 promulgated thereunder.

(b) In determining the taxable net income of the Petitioner for the calendar year 1938, and in computing the asserted deficiency thereon, the Commissioner has asserted a penalty in the amount of $1675.13. The Petitioner claims that there was no negligence or intentional disregard of the rules and regulations in not reporting in his income tax return for the year 1938 the purchase of the voting trust certificates referred to in paragraph (a) above, and that the Commissioner unlawfully and erroneously assessed such penalty under the provisions of Section 293 (a) of the Revenue Act of 1938.

(c) In determining the taxable net income of the Petitioner for the calendar year 193 he Commissioner erroneously included income in the amount of $71,660.98, which the Commissioner claims the Petitioner received as income by reason of his purchase from Western Cooperage Company during the calendar year [4] 1939 of voting trust certificates representing 12,404 shares of the Common Capital Stock of Hawley Pulp and Paper Company. The Petitioner claims that the said $71,-

650.98 was not income under the provisions of Section 22 (a) of the Revenue Act of 1938, or under the provisions of Regulations 101 promulgated thereunder.

(d) In determining the taxable net income of Petitioner for the calendar year 1939, the Commissioner erroneously disallowed a deduction on account of the worthlessness of four units of interest in San Juan Mining Syndicate purchased by Petitioner July 17, 1937, for $1000.00. The units in said Syndicate became worthless during the year 1939. The Commissioner disallowed a deduction to the extent of $166.66. Petitioner claims that by reason of the worthlessness of said four units of interest in San Juan Mining Syndicate during the calendar year 1939 that Petitioner should be allowed a deduction of $1000.00 as an ordinary loss under the provisions of Section 23 (e) of the Revenue Act of 1938.

(e) In determining the taxable net income of the Petitioner for the calendar year 1939, and in computing the asserted deficiency thereon, the Commissioner has asserted a penalty in the amount of $1,472.22. The [5] Petitioner claims that there was no negligence or intentional disregard of the rules and regulations in not reporting in his income tax return for the year 1939 the purchase of voting trust certificates referred to in paragraph (c) above, and that the Commissioner unlawfully and erroneously assessed said penalty under the provisions of Section 293 (a) of the Revenue Act of 1938.

V.

The facts upon which the Petitioner relies as the basis for this proceeding are as follows:

(a) On December 10, 1934, in consideration of services rendered prior to December 10, 1934, Western Cooperage Company gave to the Petitioner an option to purchase, on or before January 1, 1940, at a purchase price of 10 cents per share, the right to receive all of the Common Stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the said Western Cooperage Company. The purchase price of said stock as fixed in said option was not less than the fair market value of the said stock, or the voting trust certificates representing said stock, on December 10, 1934. The said option was subsequently ratified and [6] approved by the Board of Directors of Western Cooperage Company. Thereafter, in March, 1938, the Petitioner exercised his right under said option and purchased from Western Cooperage Company voting trust certificates representing 74,377 shares of Common Stock of Hawley, Pulp and Paper Company. The said purchase was made pursuant to and in accordance with the terms of the said option agreement at a total purchase price of $7,437.70, as provided in said option, and said purchase price was paid by Petitioner to Western Cooperage Company during the calendar year 1938.

During the calendar year 1938, in accordance with instructions given by Western Cooperage Company to the depositary holding said voting trust certificates, there was delivered to Petitioner under

the terms of said option voting trust certificates representing 33,759 shares of Common Stock of Hawley Pulp and Paper Company. The said voting trust certificates, or the Common Stock of Hawley Pulp and Paper Company represented thereby, were not received by the taxpayer during the calendar year 1938 as compensation for services, and that the taxpayer paid therefor the price agreed upon in the option agreement, which price was not less than [7] the fair market value at the time of the giving of said option on December 10, 1934.

(b) That the said option agreement given as of December 10, 1934, referred to in paragraph (a) above, was given to the Petitioner by Western Cooperage Company in payment of services rendered prior to December 10, 1934, and that the said option on December 10, 1934, was considered of only nominal value, and if the Petitioner received any compensation by reason of said option agreement or the receipt of shares thereunder, the said compensation was received at the time he received the option, and that the Petitioner received no compensation during the calendar year 1938 for services by reason of the receipt of said voting trust certificates or the shares represented thereby. That Petitioner was not required to report any compensation on such a transaction and the Commissioner erroneously assessed a penalty in addition to the asserted deficiency in the tax.

(c) On December 10, 1934, in consideration of services rendered prior to December 10, 1934, Western Cooperage Company gave to the Petitioner an

option to purchase, on or before January 1, 1940, at a purchase price of 10 cents per share, the right to receive all [8] of the Common Stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the said Western Cooperage Company. The purchase price of said stock as fixed in said option was not less than the fair market value of the said stock or voting trust certificates representing said stock on December 10, 1934. The said option was subsequently ratified and approved by the Board of Directors of Western Cooperage Company. Thereafter, in March, 1938, the Petitioner exercised his right under said option and purchased from Western Cooperage Company voting trust certificates representing 74,377 shares of Common Stock of Hawley Pulp and Paper Company. The said purchase was made pursuant to and in accordance with the terms of the said option agreement at a total purchase price of $7,437.70, as provided in said option, and said purchase price was paid by Petitioner to Western Cooperage Company during the calendar year 1938.

During the calendar year 1939, in accordance with instructions given by Western Cooperage Company to the depositary holding said voting trust certificates, there was delivered to Petitioner under the terms of said option, voting trust certificates representing 12,404 shares of Common Stock of Hawley Pulp and Paper Company. [9] The said voting trust certificates or the Common Stock of Hawley Pulp and Paper Company represented thereby were not received by the taxpayer during the calendar year 1939 as compensation for services, and that

the taxpayer had theretofore in 1938 paid for said shares the price agreed upon in the option agreement, which price was not less than the fair market value at the time of the giving of said option on December 10, 1934.

(d) That on July 17, 1937, the Petitioner purchased, for the sum of $1000.00, four units of interest in San Juan Mining Syndicate. Thereafter, and on or about April 25, 1939, the said San Juan Mining Syndicate found that it was unable to properly finance itself, and lost all of its properties or rights to property during the calendar year 1939. The San Juan Mining Syndicate was dissolved on or about April 25, 1939. There was no distribution of assets and no assets left to distribute to the owners of the units of interest, and the Petitioner has received no dividends, either liquidating or otherwise, from said San Juan Mining Syndicate, and said units were determined to be worthless in the calendar year 1939. The loss sustained by the Petitioner was in the sum of $1000.00, and was an ordinary loss deductible [10] from gross income under the provisions of Section 23 (e) of the Revenue Act of 1938.

(e) That the option agreement given as of December 10, 1934, referred to in paragraph (c) above was given to the Petitioner by Western Cooperage Company in payment of services rendered prior to December 10, 1934, and that the said option on December 10, 1934, was considered of only nominal value, and if the Petitioner received any compensation by reason of said option agreement or the receipt of shares thereunder, the said compensation

was received at the time he received the option, to-wit, December 10, 1934, and that the Petitioner received no compensation during the calendar year 1939 for services by reason of the receipt of said voting trust certificates or the shares represented thereby. That Petitioner was not required to report any compensation on such a transaction and the Commsisioner erroneously assessed a penalty in addition to the asserted deficiency in the tax.

VI.

That the Petitioner is entitled to have his tax redetermined for the calendar years 1938 and 1939, and contends that there is no further tax due for the [11] calendar years 1938 and 1939, and that for the calendar year 1939 there should be refunded to the Petitioner the sum of $70.00 by reason of Petitioner's failure to deduct the full amount of his loss occasioned by the worthlessness of four units in San Juan Mining Syndicate, which were determined to be worthless and written off during the calendar year 1939.

Wherefore, Petitioner prays that the Board may hear the proceeding and determine that there is no deficiency due from the Petitioner for the calendar years 1938 and 1939, and that for the calendar year 1939 there was an overpayment of tax in the amount of $70.00, and that the Petitioner is entitled to a refund in the sum of $70.00, together with interest

thereon at the rate of 6 per cent. per annum from December 15, 1940.

JOHN H. SMITH,
Petitioner.
(Sgd) CLARENCE D. PHILLIPS
Clarence D. Phillips,
805 Electric Building,
Portland, Oregon,
Attorney for Petitioner.

Counsel:
Griffith, Peck, Phillips & Nelson,
805 Electric Building,
Portland, Oregon.
(Duly verified.) [12]

EXHIBIT A

Treasury Department
Internal Revenue Service
Seattle, Washington
January 31, 1942

Office of
Internal Revenue Agent
in Charge
Seattle Division
350 Federal Office Building

IT:90D:JW

Mr. John H. Smith,
1233 American Bank Building,
Portland, Oregon.

Sir:

You are advised that the determination of your

income tax liability for the taxable year(s) ended Dec. 31, 1938 & 1939, discloses a deficiency of $62,947.03 and $3,147.35 in penalty as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in Charge, Seattle, Washington, for the attention of IT:90D:JW. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,

By GEO. C. EARLEY,
Internal Revenue Agent in Charge

Enclosures:
Statement.
Form of waiver.
JW-bb [14]

STATEMENT

IT:90D:JW

Mr. John H. Smith,
1233 American Bank Building,
Portland, Oregon.

Tax Liability for the Taxable Years Ended December 31, 1938 and December 31, 1939

INCOME TAX

	Liability	Assessed	Deficiency	Penalty
1938	$ 35,861.77	$ 2,359.13	$ 33,502.64	$ 1,675.13
1939	32,562.87	3,118.48	29,444.39	1,472.22
Totals	$68,424.64	$ 5,477.61	$ 62,947.03	$ 3,147.35

In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated March 13, 1941, and to the revised statement dated October 1, 1941, covering the liability for the year 1939; to your protests dated June 10, 1941; and to the statements made at the conferences held on August 22, 1941, November 24, 1941, and January 13, 1942.

The advalorem penalties imposed by Section 293 (a) of the Revenue Act of 1938 and by Section 293 (a) of the Internal Revenue Code, are asserted because of your failure to report, in your returns filed for the taxable years 1938 and 1939, the transactions in those years wherein you acquired from Western Cooperage Company voting trust certificates representing shares of the common capital stock of Hawley Pulp and Paper Company for less than their

fair market value, and because of your failure to include in gross income in your said returns the differences between the amounts paid for such voting trust certificates and the amounts of their fair market values, as required by Article 22(a)-1 of Regulations 101 and by Section 19.22(a)-1 of Regulations 103.

A copy of this letter and statement has been mailed to your representative, Clarence D. Phillips, 805 Electric Building, Portland, Oregon, in accordance with the authority contained in the power of attorney executed by you. [15]

TAXABLE YEAR ENDED DECEMBER 31, 1938

Adjustments to Net Income		
Net income as disclosed by return		$ 25,868.90
Unallowable deductions and additional income:		
(a) Income understated	$81,021.60	
Net income adjusted		$106,890.50

EXPLANATION OF ADJUSTMENT

(a) During the taxable year 1938 you acquired from Western Cooperage Company, for a total price of $3,375.90, pursuant to the terms of an option granted to you by that corporation on or about May 4, 1937, voting trust certificates entitling you to receive 33,759 shares of the common capital stock of Hawley Pulp and Paper Company. The fair market value, at the time of their receipt by you, of the said voting trust certificates was $84,397.50. The excess of the latter amount over the $3,375.90 paid by you pursuant to said option constitutes in-

come to you under Section 22(a) of the Revenue Act of 1938, and is included as a part of your net income for the year 1938 in accordance with the provisions of Article 22(a)-1 of Regulations 101.

COMPUTATION OF TAX

Net income adjusted		$106,890.50
Less: Personal exemption	$2,500.00	
Credit for dependents	1,200.00	3,700.00
Balance (surtax net income)		$103,190.50
Less: Earned income credit (10% of $14,000.00)		1,400.00
Net income subject to normal tax		$101,790.50
Normal tax at 4% on $101,790.50		$ 4,071.62
Surtax on $103,190.50		31,850.49
Total tax		$ 35,922.11
Less: Income tax paid to a foreign country or U. S. possession		60.34
Corrected income tax liability		$ 35,861.77
Income tax assessed:		
Original, Account No. 20625		2,359.13
Deficiency of income tax		$ 33,502.64

[16]

TAXABLE YEAR ENDED DECEMBER 31, 1939

Adjustments to Net Income

Net income as disclosed by return		$ 29,716.90
Unallowable deductions and additional income:		
(a) Income understated	$ 71,660.98	
(b) Capital loss overstated	166.66	71,827.64
Net income adjusted		$101,544.54

EXPLANATION OF ADJUSTMENTS

(a) During the taxable year 1939 you acquired from Western Cooperage Company, for a total price of $1,240.40, pursuant to the terms of an option granted to you by that corporation on or about May 4, 1937, voting trust certificates entitling you to receive 12,404 shares of the common capital stock of Hawley Pulp and Paper Company. The fair market value, at the time of their receipt by you, of the said voting trust certificates was $72,901.38. The excess of the latter amount over the $1,240.40 paid by you pursuant to said option constitutes income to you under Section 22(a) of the Internal Revenue Code, and is included as a part of your net income for the year 1939 in accordance with the provisions of Section 19.22(a)-1 of Regulations 103.

(b) You claimed a loss of $666.66 on worthlessness of four units of interest in San Juan Mining Syndicate, purchased July 17, 1937, for $1,000.00. As the time from date of purchase to the close of the year in which worthlessness occurred was over two years, the allowable loss is limited to 50%, or $500.00. Excessive deduction, $166.66. [17]

Taxable Year Ended December 31, 1939—(Continued)

COMPUTATION OF TAX

Net income adjusted		$101,544.54
Less:		
Personal exemption	$2,500.00	
Credit for dependents	1,200.00	3,700.00
Balance (surtax net income)		$ 97,844.54

Less:	
Earned income credit (10% of $14,000.00)	1,400.00
Net income subject to normal tax	$ 96,444.54
Normal tax at 4% on $96,444.54	$ 3,857.78
Surtax on $97,844.54	28,814.50
Total tax	$ 32,672.28
Less:	
Income tax paid to a foreign country or U. S. possession	109.41
Corrected income tax liability	$ 32,562.87
Income tax assessed:	
Original, Account No. 20038	3,118.48
Deficiency of income tax	$ 29,444.39

[Endorsed]: U.S.B.T.A. Filed Mar. 2, 1942. [18]

[Title of Board and Cause.]

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein, admits and denies as follows:

1. Admits the allegations contained in paragraph I of the petition.

2. Admits the allegations contained in paragraph II of the petition.

3. Admits the allegations contained in paragraph III of the petition.

4. Denies that he erred in his determination of

the deficiencies as shown by the notice of deficiency from which petitioner's appeal is taken. Specifically denies that he erred in the manner and form as alleged in subparagraphs (a) to (e), inclusive, of paragraph IV of the petition.

5(a). Admits that in consideration of services rendered or to be rendered, Western Cooperage Company gave to the petitioner an option to purchase, on or before January 1, 1940, at a purchase price of 10 cents per share, the right to receive all of the common stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by said [19] Western Cooperage Company, that thereafter, in March, 1938, petitioner exercised his right under said option to purchase said common stock; that during the calendar year 1938, there was delivered to petitioner under the terms of said option, voting trust certificates representing 33,759 shares of common stock of Hawley Pulp and Paper Company; and that the petitioner paid therefor the price agreed upon in the option agreement. Denies the remaining allegations contained in subparagraph (a) of paragraph V of the petition.

(b) Denies the allegations contained in subparagraph (b) of paragraph V of the petition.

(c). Admits that in consideration of services rendered or to be rendered, Western Cooperage Company gave to the petitioner an option to purchase, on or before January 1, 1940, at a purchase price of 10 cents per share, the right to receive all common stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by said

Western Cooperage Company; that thereafter, in March 1938, the petitioner exercised his right under said option to purchase said common stock; that during the calendar year 1939, there was delivered to petitioner under the terms of said option, voting trust certificates representing 12,405 shares of common stock of Hawley Pulp and Paper Company; and that petitioner paid for said shares the price agreed upon in the option agreement. Denies the remaining allegations contained in subparagraph (c) of paragraph V of the petition.

(d). Admits that on July 17, 1937, the petitioner purchased, for the sum of $1,000, four units of interest in San Juan Mining Syndicate. [20] Denies the remaining allegations contained in subparagraph (d) of paragraph V of the petition.

(e). Denies the allegations contained in subparagraph (e) of paragraph V of the petition.

6. Denies the allegations contained in paragraph VI of the petition.

7. Denies generally and specifically each and every material allegation contained in the petition herein, not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the petitioner's ap-

peal be denied and that the Commissioner's determination of deficiencies be approved.

(Signed) J. P. WENCHEL, J.H.P.
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
ALVA C. BAIRD,
Division Counsel.
JOHN H. PIGG,
Special Attorney,
Bureau of Internal Revenue.

[Endorsed]: U.S.B.T.A. Filed: April 15, 1942.
JHP:wm 4-8-42 [21]

The Tax Court of the United States

Docket No. 110050

JOHN H. SMITH,

Petitioner,

vs,

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

Clarence D. Phillips, Esq., for the petitioner.
E. A. Tonjes, Esq., for the respondent.

Harron, Judge: Respondent determined deficiencies in income tax in the amounts of $33,502.64 and $29,444.39, respectively, for the years 1938 and 1939.

Respondent added penalties to the deficiencies in the amounts of $1,675.13 and $1,472.22, under section 293(a) of the Revenue Act of 1938, for negligence in failing to report the transactions which gave rise to the deficiencies. The questions in issue are: [22]

(1) Whether petitioner realized taxable income during the years 1938 and 1939 to the extent of the difference between the purchase price and the fair market value of certain stock acquired by him pursuant to an option granted by his employer in the year 1934.

(2) Whether petitioner is liable for the 5 per cent penalty.

(3) Whether petitioner sustained an ordinary loss or a capital loss on certain units of interest in the San Juan Mining Syndicate which became worthless during the year 1939.

The returns were filed with the collector of internal revenue for the district of Oregon.

FINDINGS OF FACT

Issues (1) and (2): Petitioner resides in Portland, Oregon. After the world war, petitioner became an employee of the Western Cooperage Company, an Oregon corporation, hereinafter called Western, and has been in its employ ever since. Petitioner has been employed in different executive capacities with Western; at the present time, he is general manager of the company.

Prior to 1933, the Hawley Pulp and Paper Com-

pany, a Delaware corporation, hereinafter called Hawley, was having financial difficulties. Among its liabilities were outstanding bonds, and a bondholders' protective committee was formed. Western, at the request of the bondholders' committee, took over the management of Hawley. A reorganization committee was appointed. This committee submitted a plan of reorganization, dated [23] as of January 18, 1934, which was adopted during the year 1934. Petitioner personally took an active part in the reorganization. He interviewed many of the holders of the Hawley securities and was successful in getting a substantial amount of securities deposited under the reorganization plan.

The reorganization plan provided that Western would, at its option, continue to manage Hawley as long as it was not in default under the plan. The management, under Western, was to retire annually a certain amount of the outstanding indebtedness during each year. Compensation for management was provided for as follows: When the amount of $1,400,000 of the total indebtedness of $2,790,150 was retired, the depositary, The Bank of California, National Association, was to deliver shares of Hawley's second preferred stock and voting trust certificates of common stock, hereinafter called common stock, to Western. The amount of stock to be delivered was that number of shares which would bear the same ratio to the total shares deposited as the amount of indebtedness retired bore to the total indebtedness. There after the re-

maining shares of second preferred stock and common stock were to be delivered to Western on the same basis. There were deposited with the depositary 174,378 shares of common stock of Hawley pursuant to the reorganization plan.

In December of 1934, Watson Eastman, who was president and general manager of Western, gave a verbal option to petitioner as a reward for services rendered by petitioner prior to December 10, 1934, in connection with the reorganization of Hawley. [24]

Upon advice of counsel, Western, by corporate resolution, dated May 4, 1937, authorized the execution and delivery of a formal written option, dated as of December 10, 1934, embodying the same terms as the oral option. This resolution stated, in part, that the president of Western had given "to John H. Smith, in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company and in bringing about the deposit of securities enabling the confirmation of said plan by decree of the District Federal Court of Portland, Oregon, an option", and "that the executive officers of this corporation be authorized and directed on behalf of this corporation to execute and deliver, as of the 10th day of December, 1934, to John H. Smith, a formal option substantially setting forth the option and the terms and provisions thereof as hereinbefore in this resolution recited."

Western, pursuant to the above resolution, exe-

cuted a written option as of December 10, 1934. The written option provided, inter alia, as follows:

> * * * in consideration of services rendered by John H. Smith of Portland, Oregon, hereinafter called "said Smith", prior to the date hereof, in negotiating the plan of reorganization as set forth in the reorganization indenture between Hawley Pulp and Paper Company, hereinafter called the "Hawley Company", and its depositing security holders of date January 18, 1934, and in bringing about the deposit of securities enabling the confirmation of said plan, does hereby, on this 10th day of December, 1934, grant unto the said John H. Smith, his heirs or assigns, the following several options, either one of which, or both of which, may be exercised by the said Smith, his heirs or assigns, upon compliance by him or them with the terms of the option which is being exercised by him or them; said options are expressed and conditioned as follows, to-wit: [25]
>
> * * * *
>
> OPTION B.
>
> 1. To purchase on or before January 1, 1940, at a price of $7437.70, the right to receive all common stock of the Hawley Company in excess of 100,001 shares of the common stock of the Hawley Company to be received by the Cooperage Company in the performance of its management contract referred to in said plan of reorganization.

2. This option shall be void unless exercised by the said Smith, his heirs or assigns, on or before January 1, 1940.

3. It is possible that the said Smith, his heirs or assigns, may exercise this option and that the said Cooperage Company, by reason of management defaults, may be entitled to receive only a portion of the Common Stock of the Hawley Company placed in escrow under said reorganization plan, and if such be the case then the Cooperage Company will, upon such exercise of this option and upon the written request of said Smith so to do, file with the Depositary holding said Common Stock in escrow under the terms of said reorganization plan a written notice that it has sold to said Smith, his heirs or assigns, its right to receive under said reorganization plan 74,377 shares of the Common Stock of the Hawley Company, and with said written notice the Cooperage Company will file with said depositary a written order directing the said Depositary to thereafter deliver to the Cooperage Company and said Smith, his heirs or assigns, the Common Stock of the Hawley Company held by it in escrow and which the Cooperage Company may be entitled to receive, in the proportion of six shares to the Cooperage Company and four shares to the said Smith, his heirs or assigns, until the Cooperage Company shall have received 100,001 shares and the said

Smith, his heirs or assigns, shall have received approximately 66,667 shares, and thereafter to deliver the balance of said stock of approximately 7,710 shares to the said Smith, his heirs or assigns.

4. In case this option shall be exercised by said Smith, his heirs or assigns, and if the Cooperage Company may have earned the release to it of said stock in accordance with the provisions set forth in said reorganization plan, then all such deliveries of said Common Stock shall be made by the said Depositary to said Cooperage Company and to said Smith, his heirs or assigns, in the proportion in the next preceding paragraph stated.

5. This option may be exercised at any time hereafter until January 1, 1940, by the delivery by said Smith, his heirs or assigns, to the Cooperage Company of his or their written declaration of the exercise of this option together with the option price of Seven thousand four hundred thirty-seven and 70/100 Dollars ($7437.70). [26]

On or before March 18, 1938, Western reduced the outstanding indebtedness of Hayley by the amount of $1,409,720.

Petitioner, in March of 1938, exercised his option and paid Western the amount of $11,180.70, by check dated March 21, 1938, which represented the payment of $7,437.70 for 74,377 shares of com-

mon stock at ten cents a share, and $3,743 for 3,743 shares of second preferred stock at one dollar a shares. The preferred stock is not involved in this proceeding.

Western, by order dated March 18, 1938, made demand on the depositary to deliver 50,939½ shares of Hawley common stock to Western, and 33,759 shares of such common stock to petitioner.

During the years 1938 and 1939 petitioner received shares of Hawley common stock as follows: 33,759 shares on March 19, 1938; 3,661 shares on February 3, 1939; 2,680 shares on November 1, 1939; and 6,033 shares on December 28, 1939; total number of shares received in 1939, 12,374.

On December 10, 1934, the common stock of Hawley had a market value of not more than ten cents a share.

Western, in recording the receipt of $7,437.70 from petitioner, debited cash and credited an account entitled "John H. Smith Investment". When petitioner received the stock, the same account was debited, and the Profit and Loss Account for 1938 was credited with the amount of $7,437.70. In its income tax return for the year 1938, Western reported this transaction with petitioner as resulting in a capital gain of $7,437.70, with the explanation, "Sale of our right to receive 74,377 Shares Common Stock of Hawley Pulp and Paper Company".

[27]

Petitioner did not report any income for the year 1934 on account of the receipt of the option. Pe-

titioner did not report in his returns for the years 1938 and 1939, his acquisition of the common stock of Hawley.

Respondent determined that the common stock of Hawley, received by petitioner during the years 1938 and 1939 had a fair market value at the time the stock was received in the respective amounts of $84,397.50 and $72,901.38, and that, accordingly, petitioner realized income to the extent of the excess of the fair market value over and above the price paid for the stock upon the exercise of the option.

During the years 1940 and 1941, petitioner sold approximately 31,939 shares of common stock of Hawley. Petitioner reported these sales and used ten cents a share as a cost basis in computing his gain.

The excess of the fair market value over the option price of the common stock of Hawley, received by petitioner during the taxable years, constituted income to petitioner in the respective amounts of $81,021.60 and $71,663.98.

Petitioner's failure to report income from the receipt of the Hawley stock in each taxable year was due to an honest mistake of law and was not due to negligence or an intentional disregard of respondent's regulations.

Issue (3): On July 17, 1937, petitioner purchased four units of interest in the San Juan Mining Syndicate for the total sum of $1,000. The said units of interest became worthless on or about April 25, 1939. Petitioner did not receive any money

by reason of the liquidation of this syndicate and charged off on his books as worthless all interest in the syndicate. [28]

OPINION

Issue (1). The question is whether the difference between the option price and the fair market value of the common stock acquired pursuant to the option is taxable as a gain resulting from a bona fide sale and purchase, or as compensation to petitioner for personal services. If the gain constituted compensation to petitioner, it is taxable as income in the years when the stock was received.

Respondent added the sums of $81,021.60 and $71,660.98[1] to petitioner's net income for the years 1938 and 1939, respectively, upon the theory that such amounts represented additional compensation received by petitioner in each of the taxable years. Respondent determined that these sums, which were the excess of the fair market value over the option price of the common stock acquired by petitioner pursuant to the option, were income under section 22(a) of the Revenue Act of 1938. Section 22(a) defines "gross income" as including "gains, profits, and income derived from salaries, wages, or com-

(1) This amount is the difference between the cost of 12,404 shares at 10 cents a share, and a fair market value of $72,901.38. At the hearing it was shown that the total number of shares received in 1939, at various dates, was 12,374 shares, but that the total fair market value was not other than $72,901.38, with this correction, the difference between the cost and the fair market value is $71,663.98 as stated in the findings of fact.

pensation for personal service, of whatever kind and in whatever form paid * * *". Article 22(a) (1) of Regulations 101, promulgated under the provisions of the Revenue Act of 1938, provides in part as follows:

> * * * If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * * [29]

Petitioner has not contested respondent's determination of the fair market value of the stock received by petitioner during the taxable years. Therefore, if it is found that the difference between the option price and the fair market value of the stock was compensation to petitioner, respondent must be sustained.

Petitioner contends this differential was not compensation for personal services, but a gain resulting

from a bona fide purchase and sale. Petitioner has cited a number of cases in support of his contentions. These cases merely hold that under the facts of each case, the options were not given as compensation for services, but for some other reason such as to increase the employee's interest and proprietary attitude toward the employer corporation.

Respondent relies on Estate of Edward J. Connolly, 45 B. T. A. 374 (appealed CCA 6, January 15, 1942). In that case it was stated:

> The facts in the instant proceedings show that the options given to Connolly and to Anderson were for the purpose of granting them additional compensation for services already performed and currently being performed. If Connolly and Anderson upon the receipt of those options had immediately exercised them, we think it would have to be held that each received taxable income of the difference between the amount paid for the shares and their fair market value. See Edward J. Epsen, 44 B. T. A. 322. Connolly and Anderson did not, however, exercise the options during 1935. They waited until January 30, 1936, at which time the fair market value of the shares was $5 per share. Quite clearly the Hayes Body Corporation paid Connolly and Anderson no additional compensation in 1935. If the options had never been exercised the optionees would never have received any additional compensation. But when the options were exercised the company parted with shares of stock which could have been sold at $5 per share. * * *

Petitioner was instrument in consummating the reorganization plan of Hawley. Under the plan, Western would receive considerable compensation if [30] it was successful in its management of Hawley. It is indisputable that Western gave the option to petitioner as compensation for services rendered in effecting the reorganization plan of Hawley. It is so stated in the Western corporate resolution and in the option itself. Furthermore, petitioner testified that the option was given to him as compensation for such services. If petitioner had not exercised the option, Western would have received all of the Hawley common stock. When petitioner exercised his option and received the stock, Western parted with the right to receive stock which had a much greater value than the option price. Under the reasoning of the Connolly case, petitioner received compensation to the extent of the differential.

Petitioner has suggested several factual dissimilarities in this case to distinguish it from the Connolly case, which are not material. The basic facts are that petitioner was given an option as compensation for services and that he realized gains in the taxable years pursuant to the exercise of this option. It is a settled rule that when an option is given to an employee as compensation for services, rendered or to be rendered, the gain realized through the exercise of such option is taxable as realized compensation. Albert Russel Erskine, 26 B. T. A. 147; Edward J. Epsen, supra; and Estate of Edward J. Connolly, supra.

Accordingly, it is held that the difference between the option price and the fair market value of such common stock acquired by petitioner pursuant to the option was taxable as compensation received by petitioner in the taxable years. [31]

Issue (2). Respondent has imposed the negligence penalty under section 293(a) of the Revenue Act of 1938[2], because of petitioner's failure to report in his return income realized from a transaction discussed under Issue (1). The statute is so worded that the taxpayer is allowed to show that his omission in his tax return was without intent to defraud and was without intentional disregard of rules and regulations. If the taxpayer shows that there has not been any negligence or an intentional disregard of rules and regulations, he may establish that he is not liable for the penalty.

The transaction between Western and petitioner was of such nature that the effect in the taxable year upon petitioner's income tax liability involved a construction of law which in and of itself is difficult. We are satisfied from the record that peti-

(2) Sec. 293. Additions to the Tax in Case of Deficiency.

(a) Negligence.—If any part of any deficiency is due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency, except that the provisions of section 272(i), relating to the prorating of a deficiency and of section 292, relating to interest on deficiencies, shall not be applicable.

tioner's failure to report the excess of the fair market value of the stock over the option price as income was due [32] to an honest misunderstanding of law and not to negligence or intentional disregard of regulations.

Western treated the transaction as a sale and not as compensation. Petitioner, under a misunderstanding of the law, took the same view. It is held that the penalty provided for under section 293(a) should not be imposed upon the petitioner.

Issue (3). The question is whether the syndicate units which had been purchased on or about July 17, 1937, and which became worthless in the year 1939 were "securities" as defined in section 23(g)(3) of the Revenue Act of 1938.[3] Respondent determined that the interests in the syndicate were tantamount to shares of stock, and that they were capital assets under section 117(a). Respondent held then that when the interests in the syndicate became worthless in 1939, the allowable loss was limited by the provisions of section 117, the loss being considered as a loss from the sale or exchange of a capital asset, under 23(g)(2).[3] Since they had been held for

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(3) Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(g) Capital Losses.—

* * * * *

(2) Securities Becoming Worthless.—If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this title, be considered as a loss from the sale

more than two years, [33] respondent held that the allowable loss was 50 percent or $500, under section 117(b) Petitioner in his return for the year 1939 deducted the amount of $666.66 as a capital loss. Petitioner now contends that he is entitled to deduct the entire amount of the cost of the interests, as an ordinary loss under section 23(a)(2). Petitioner claims that he has overpaid the tax because of an understatement of the loss.

In our opinion respondent's determination must be sustained under section 23(g) (2). Petitioner has failed to show that the syndicate was not a "corporation" within the meaning of that term as defined by section 901(a) (2).[4] The term corporation includes associations. It is a question of fact whether or not a syndicate is a "corporation" for purposes of the revenue act. Petitioner has not submitted any evidence relating to the nature of the organization of the San Juan Mining Syndicate. It is impossible, for failure of proof, to hold that this syndicate was not an association or a corporation, under the statute, in the nature of its structure. Petitioner

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or exchange, on the last day of such taxable year, of capital assets.

(3) Definition of Securities.—As usual in this subsection the term "securities" means (A) shares of stock in a corporation, and (B) rights to subscribe for or to receive such shares.

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[4] Sec. 901. Definitions.

(a) When used in this Act—

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies.

has failed to meet his burden of proof on this question.

It is held that the loss deduction is limited to $500 under section 23(g)(2).

Decision will be entered under Rule 50.

Entered Feb 26 1943 [34]

The Tax Court of the United States
Washington

Docket No. 110050

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the Memorandum Findings of Fact and Opinion entered on February 26, 1943, respondent, on March 18, 1943, filed recomputation of the deficiency under Rule 50. Upon due notice of a hearing on the recomputation, petitioner did not file objection thereto. Accordingly, it is

Ordered and Decided: That there are deficiencies in income tax liability for the years 1938 and 1939 in

the respective amounts of $33,502.64 and $29,446.16, and that no penalties are due.

[Seal] (Signed) MARION J. HARRON
Judge

Entered Apr-7-1943.
evd— [35]

[Stamped] Received Jun 9—1943 The Tax Court of the U.S.A.

[Endorsed]: Filed Oct. 14, 1942.

United States Board of Tax Appeals
[Title of Cause.]

REPORTER'S MINUTES

Hearing at Portland, Oregon,
On the 17th day of September, 1942,
at 7:50 P. M.

The above entitled proceeding came on for hearing on the 17th day of September, 1942, before the Honorable Marion J. Harron, Member of the United States Board of Tax Appeals, at Portland, Oregon, pursuant to notice of hearing heretofore given, whereupon the following proceedings were had, to-wit:

Appearances:

C. D. PHILLIPS, Esq.,
805 Electric Building, Portland, Oregon
appearing on behalf of the Petitioner.

E. A. TONJES, Esq.,
appearing on behalf of the Commissioner of Internal Revenue, Respondent. [36]

PROCEEDINGS

The Member: Docket No. 110050, John H. Smith. State your appearances. Are you ready?

Mr. Phillips: The Petitioner is ready, your Honor.

Mr. Tonjes: Respondent is ready.

The Member: Then state your appearances, will you please, to the reporter.

Mr. Phillips: Clarence D. Phillips, attorney for the Petitioner.

Mr. Tonjes: E. A. Tonjes (spelling), appears for the Respondent.

The Member: The Respondent has determined the deficiency in income tax in 1938 in the amount of $35,502.64 and in 1939 in the amount of $29,044.39, and a penalty has been determined in addition. What is the question in the case, Mr. Phillips?

Mr. Phillips: If your Honor please, we have two issues in the case. The first has developed around an option. And I assume that your Honor wants a little background in the opening statement.

The Member: No, I don't think we have time for that. I want to know what the question is.

Mr. Phillips: The question is, your Honor, whether or not $74,377 shares of stock were earned by the Western—of stock of the Hawley Pulp & Paper Company, which the [38] Western Cooperage Company acquired right to receive in connection with the reorganization of the Hawley Pulp & Paper Company. This is common stock. They also acquired the right to acquire a certain second preferred stock. And mentioned in this connection, this com-

mon stock was the matter of oral option to Mr. Smith of the Western Conperage Company in December of 1934. In 1937 that oral option was made the subject of a written option agreement, to be dated January 4, 1940. Mr. Smith exercised the option on January, 1938, and paid for all of the common stock he was entitled to receive under that option. The option price on the common stock was 10c, which was the reflected market price, or, at least in excess of the market price as of December 10, 1934. The Commissioner contends in this case that Mr. Smith received some 33,000 shares in 1938 at the option price of 10c a share and in 1939 received the balance of it, is their contention, and that they claimed Mr. Smith received income to the extent of the difference between the market price in 1938 and 1939 respectively. The other issue was a small issue with respect to a loss in interest in the San Juan Mining Syndicate, in which Mr. Smith purchased an interest in 1937 and this syndicate went out of business, they contend, they liquidated in 1939, with no recovery to parties of the syndicate in 1939, and in that return he asked for a loss on a capital loss basis and it was disallowed; as a matter of fact, we have asked in this [39] appeal that he be allowed a full loss on the basis of an ordinary business loss.

The Member: Do the Respondents have a statement?

Mr. Tonjes: I don't think there is any further statement on my part, your Honor. Those are the issues as I understand them.

The Member: All right. Will you proceed.

Mr. Phillips: Are you ready for the witnesses?

The Member: Yes.

Mr. Phillips: Call Mr. Smith. You will sit over here, Mr. Smith, and be sworn, please.

The Clerk: State your name for the reporter, please.

The Witness: John H. Smith.

JOHN H. SMITH

was called as a witness for and on behalf of himself, and having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Phillips:

Q. Your name is John H. Smith?

A. It is, and I believe in these tax reports it is recorded as John H. Smith, Jr., for the matter of continuity.

Q. John H. Smith, Jr., when referring to it, when it is referred to in any of these documents or records, is the [40] same as John H. Smith?

A. Correct.

Q. Where do you reside, Mr. Smith?

A. At 11476 River Road, Portland, Oregon.

Q. And how long have you lived in Portland?

A. Since 1919.

Q. What is your present occupation?

A. President of the Hawley Pulp & Paper Company and general manager of the Western Cooperage Company.

Q. Now, in order to get a little background of

(Testimony of John H. Smith.)

your experience in the event subsequently you might need some qualification and experience, will you tell us what schools you have attended, first?

A. How far back should I go?

Q. Well, just briefly, you might tell us where you went to grade school and high school, if any, and so forth.

A. I went to grade school at Astoria, Oregon, the place of my birth. I went to high school at what was known as a prep school named Troop in Pasadena, California, and also a very short time to the high school in Astoria and then also went to college in California, as far as the college was concerned.

Q. You are a graduate of California?

A. No. While I was in there and before graduating I left because of the last World War. [41]

Q. Then you entered the war service, and after the war service what has been your business experience?

A. After the World War I entered the employment of the Western Cooperage Company and have been with them ever since.

Q. What is your capacity, what was it when you first entered their employment?

A. As timber manager.

Q. Did you have any particular locality or in general?

A. In general, in most of their timber interests was in Pasco County, Oregon, which is the same county Astoria is located in.

(Testimony of John H. Smith.)

Q. So that since that time, have you had any other capacity since that time with the Western Cooperage Company?

A. Yes, I have, as Oregon manager and assistant general manager and general engineer to the present time.

Q. At the present time you are general engineer?

A. Yes, sir.

Q. Are you also familiar with the set-up of the Oregon Pulp & Paper Company, that is, the corporation that issued stock which is in question in this proceeding? A. I am.

Q. And when did you first have knowledge of a connection with them?

A. My first knowledge of Hawley was very superficial knowledge and just in a general way for many years past. The [42] first intimate knowledge would be in,—early in 1932 when there was, I believe that was about the date, when there was a bond committee formed of which my immediate superior, Mr. Watson Eastman was chairman and he compared and cooperated with me on various subjects at that time.

Q. Now, that was in 1932? A. As I recall.

Q. With respect to Hawley Pulp & Paper Company at that time and just prior to that time, do you know whether they were having any financial difficulties?

A. Yes. They were, in spite of the fact the committee,—the bond committee was organized.

Q. Then the bond committee, after organization,

(Testimony of John H. Smith.)

did they take control or develop the Hawley Pulp & Paper for operation purposes?

A. The bond committee I am referring to did not take control. They investigated the files of the company and made certain recommendations and later on there was another bond committee organized. The first committee did not solve the financial difficulties or difficulty of the company.

Q. At that time was the Western Cooperage Company interested in any way financially in the Hawley Pulp & Paper Company?

A. At that time the Western Cooperage Company had some Hawley bonds, as I recollect, some $27,000, par value, that [43] was the only connection with it.

Q. You mentioned Mr. Watson Eastman. Did he personally have some financial interest in the Hawley's?

A. He had no,—he had no interest except with the bond committee, he was on the bond committee and that was all, as I recall.

Q. Now, the Western Cooperage Company, will you tell the Board what is the business of the Western Cooperage Company, what Mr. Eastman has to do with respect to the Western Cooperage?

A. Watson Eastman was president and general manager of the Western Cooperage Company.

Q. Will you explain briefly what sort of a corporation the Western Cooperage Company is, that is, with respect to the stock, whether it is rather

(Testimony of John H. Smith.)

closely held or a closed or open organization, or whatever it is?

A. The Western Cooperage Company is an Oregon organization with the stock rather closely held. I would say that at least 80% of it is held in two families and virtually a 100% held in the same two families or the employees of the Western Cooperage Company.

Q. Now, from 1932 up and through the remainder of the life of Watson Eastman, will you state briefly what part did he play in the management of the Western Cooperage Company?

A. Will you repeat that question again, please?

[44]

Q. I say, from 1932 on up through to the time of his death, what part did Major Watson Eastman play in the management of the affairs of the Western Cooperage Company?

A. He was president and general manager.

Q. And did they have occasion to conduct their affairs similarly with regular board meetings or was their business transacted somewhat informally?

A. Why, I would say the business was transacted informally, in that they regularly held an annual meeting with infrequent board meetings. The board meetings being held only when there was some particular urgency to,—such as the sale of some real estate or something of that sort which had to be attended to with the board meetings and probably they would not average over two a year, other than the annual meeting.

(Testimony of John H. Smith.)

Q. And at the board meetings, then, who actually ran the affairs of the corporation, besides the board meetings?

A. Watson Eastman.

Q. Major Watson Eastman. Now, with respect to the Hawley reorganization work, will you explain to the Board what transpired chronologically with respect to the Hawley Pulp & Paper Company from the time you know of it in 1932 up until 1934?

A. There was a bond protective committee organized that, as I recall, as early as 1932, it might be slightly earlier, such as late in 1931. What committee investigated [45] the affairs of the Hawley Pulp & Paper Company. Made certain recommendations which were adopted and dissolved. Subsequent to their dissolving the Hawley Pulp & Paper Company, they got in still worse financial condition and passed their bond interest so that another bond holders' protective committee was organized and functioned for a considerable time. I—in excess of six months. And I think that probably considerable in excess of six months. They studied the affairs of the corporation and they finally proposed a reorganization under 77B, and that reorganization was eventually adopted, but during that time this bondholders' protective committee advised the Western Cooperage Company to take over the management of the Hawley Pulp & Paper Company and that was done in December of 1932 and continued until subsequent to 1934.

Q. Now, right in there, for the purpose of the

(Testimony of John H. Smith.)

Board, will you outline briefly the financial structure of the Hawley Pulp & Paper Company at that time with respect to their bonds, their notes and stocks?

A. At the time——

Q. (Interposing) When you say at that time, let us take that and peg it down to a date and see when the Western Cooperage Company took over.

A. (Continuing) ——at the time when they took over, when the Western Cooperage Company took over in December of 1932, the Hawley Pulp & Paper Company had outstanding bonds, [46] as I recall, of $2,127,500, of which interest had accrued and was in default. I forget the amount of the interest. They had a note outstanding of $500,000, on which the interest had accrued and had passed due date and so I would say the note was in default. It had $200,000 of 7% preferred stock and 8,000 shares of 6, 6% preferred stock, and 200,000 shares of common stock.

Q. The 8,000 shares is the second preferred?

A. The second preferred, the 6%.

Q. Now, in 1932, prior to the time the Hawley Pulp & Paper Company took over the management of the Hawley Pulp & Paper Company, or I mean the Western Cooperage Company took over the management of the Hawley Pulp & Paper Company, will you state whether or not they took over that management of voluntarily, you might say, or rather involuntarily took it over?

A. Well, I can't say whether it was voluntary

(Testimony of John H. Smith.)

or involuntary. I would have to recite what happened.

Q. Well, recite what happened, then.

A. The Western Cooperage Company was requested to take over the management and refused to do so on the basis that we did not have enough financial interest to make it worth our consideration. We were still requested, and that request was pressed until finally, to bring the matter to a head, we stipulated the conditions on which we would take over the [47] management, thinking the conditions we stipulated were so severe that they would end the matter by their not accepting, but instead of that our conditions were accepted and we took over the management.

Q. Now, through 1933, then, were plans being formulated for a reorganizing of this organization, the Hawley Pulp & Paper Company?

A. They were.

Q. And were they culminated in a plan of reorganization eventually?

A. They were.

Q. And about what time did that formulation itself develop into a plan of reorganization?

A. The plan, as I recall it, is dated January 1, 1934. However, you said culminated in a plan.

Q. Well, I don't mean by that approved by the company or approved by the security holders, a plan—the formulation of a plan?

A. I would say,—I would say that the plan culminated in that it received the approval of the

(Testimony of John H. Smith.)

bondholders committee, shortly after January 1, 1934, excepting there was a string on it. The bondholders committee was in disagreement and—but they all agreed that that plan was the best plan of the various things talked about, unless the company could be sold and the bondholders should get what they could on the theory [48] they were the senior security.

Mr. Phillips: If your Honor please, we will offer in evidence at this time for identification the copy of the reorganization indentures, which include a copy of the plan of reorganization.

The Member: All right. There is no objection?

Mr. Tonjes: No objection.

Mr. Phillips: It is just preliminary. It has not a direct connection with the issues but I think it is quite explanatory and might be useful.

The Member: All right, mark it Petitioner's Exhibit 1.

(Reorganization indentures referred to was marked Petitioner's Exhibit No. 1 for identification.)

(Testimony of John H. Smith.)

PETITIONER'S EXHIBIT No. 1.

Reorganization Indenture
(Including Deposit Agreements)

Between
Hawley Pulp and Paper Company
and
Depositing Security Holders
of
Hawley Pulp and Paper Company

Dated January 18, 1934

Providing for a reorganization of the Hawley Pulp and Paper Company.

Reorganization Indenture

This Reorganization Indenture, dated as of January 18, 1934, between Hawley Pulp and Paper Company, a corporation of Delaware, hereinafter called the "Company", and such holders of its securities, as hereinafter described, as shall become parties to this agreement in the manner hereinafter provided, and the holders from time to time of Deposit Receipts issued pursuant to the consummation of the plan of reorganization as hereinafter provided: Witnesseth:

First, Whereas, the Board of Directors of the Company did, on June 30, 1933, deem it to be in the best interest of the Company and its security hold-

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

ers to evolve and consummate some plan of financial reorganization, and to that end did, by resolution appoint a reorganization committee, which as presently constituted, is as follows:

Isaac D. Hunt and E. S. Collins, of Portland, Oregon, representing the bondholders,

W. Lair Thompson, of Portland, Oregon, representing the noteholder,

A. S. Kerry of Seattle, Washington, representing the stockholders, and

Watson Eastman, of Portland, representing the management;

and,

Second, Whereas, the said reorganization committee did, on January 18, 1934, submit to the Board of Directors of said Company the following "plan" of reorganization:

Report of the Reorganization Committee
of
Hawley Pulp and Paper Company
Portland, Oregon, January 18, 1934.

To the Security Holders of Hawley Pulp and Paper Company:

The undersigned reorganization committee, consisting of Isaac D. Hunt and E. S. Collins, representing the bondholders, W. Lair Thompson, representing the note holder, A. S. Kerry, representing the stockholders, and Watson Eastman, representing the management, as appointed by the Board of Directors of Hawley Pulp and Paper Company, hereinafter called "said company", recommends the

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

following plan of reorganization:

1. Description of Securities: The bonds outstanding under the mortgage and deed of trust, hereinafter called "said mortgage", from said company to The Bank of California, National Association, Trustee, of date July 1, 1926, note and stock liability of said company to be considered in reorganization is as follows:

6% First Mortgage Bonds due 7/1/46	$2,127,500.00	
Interest accrued to 1/1/34	127,650.00	$2,255,150.00
Hereinafter called "Bonds"		
7% Note due 7/1/34	500,000.00	
Interest accrued to 1/1/34	35,000.00	535,000.00
Hereinafter called "Note"		
20,000 shares First Preferred $7 Cumulative no par stock	2,000,000.00	
Cumulative dividends to 1/1/34	420,000.00	2,420,000.00
Hereinafter called "First Preferred Stock"		
8000 shares Second Preferred Cumulative no par stock, hereinafter called "Second Preferred Stock"		
200,000 shares no par Common Stock, hereinafter called "Common Stock"		

2. Voting Trust of First Preferred Stock: By reason of default in the payment of dividends on the First Preferred Stock, the voting power of said company in the matter of the election of a Board of Directors is exclusively lodged in the First Preferred Stock, and will continue in the First Preferred Stock until all cumulative dividends on the First Preferred Stock have been declared and paid,

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

or set apart for payment. In order to control the election of a Board of Directors as contemplated under this plan of reorganization, it is recommended that at least a majority of the First Preferred Stock be placed in a voting trust under the terms of which trust the members of the Permanent First Preferred Stockholders' Committee, as trustees will elect directors of said company as recommended by the several committees as hereinafter provided.

3. Permanent Bondholders' Committee: After consultation with the bondholders, the following permanent bondholders' committee is appointed:

J. C. Ainsworth, Portland, Oregon
L. R. Banks, Portland, Oregon
E. S. Collins, Portland, Oregon
Issac D. Hunt, Portland, Oregon
A. S. Kerry, Seattle, Washington

4. Permanent Noteholder Committee: After consultation with the noteholder, the following permanent noteholder committee is appointed:

M. P. Griffiths, Seattle, Washington
Geo. Leib, San Francisco, California
W. Lair Thompson, Portland, Oregon

5. Permanent First Preferred Stockholders' Committee: After consultation with the First Preferred Stockholders, the following permanent First Preferred stockholders' committee is appointed:

J. R. Bowles, Portland, Oregon

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

Arthur Devers, Portland, Oregon
Franklin T. Griffith, Portland, Oregon
Fred Gronnert, Portland, Oregon
Jos. T. Peters, Portland, Oregon

6. Permanent Second Preferred and Common Stockholders' Committee: After consultation with the Second Preferred and Common stockholders, the following permanent Second Preferred and Common Stockholders' committee is appointed:

J. H. Smith, Portland, Oregon
Eugene Bashore, San Francisco, California
T. Henry Boyd, Portland, Oregon

7. Perpetuation of Committees: In case of any vacancy in any of the above named committees by reason of death, resignation or otherwise, such vacancy in each of said committees, except as to the permanent noteholder committee wherein a vacancy shall be filled by election of any person by the surviving members of such committee, shall be filled by election by the surviving members of such committee from the same class of security holders which the committee is representing; each of such committees as hereby constituted, or as same may be constituted in election by survivors, shall continue until retirement as hereinafter provided; the action of each committee shall be governed by a majority vote of the membership of the committee as then constituted.

8. Board of Directors: The affairs of said com-

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

pany shall be handled by a Board of seven Directors, who shall appoint all officers of said company.

The said voting trustees of the First Preferred stock, under the terms of the said voting trust agreement, shall elect Directors as follows:

(A) Four Directors to be nominated by said permanent bondholders' committee;

(B) One Director to be nominated by said permanent noteholder committee;

(C) One Director to be nominated by said permanent First Preferred Stockholders' committee;

(D) One Director to be nominated by said permanent Second Preferred and Common stockholders' committee.

If and when the bondholders' committee shall retire as hereinafter provided, then the said Board of Directors shall be elected by said voting trustee as follows:

(A) Four Directors to be nominated by said permanent noteholder committee;

(B) Two Directors to be nominated by said permanent First Preferred stockholders' committee;

(C) One Director to be nominated by said permanent Second Preferred and Common stockholders' committee.

If and when said permanent noteholder committee shall retire as hereinafter provided, then the

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

said Board of Directors shall be elected by said voting trustees as follows:—

(A) Four Directors to be nominated by said permanent First Preferred stockholders' committee;

(B) Three Directors to be nominated by said permanent Second Preferred and Common stockholders' committee.

If and when all accrued and accumulated dividends upon the First Preferred stock shall have been declared and paid, or set apart for payment, then the said voting trust agreement shall terminate and the Board of Directors shall be elected by the stockholders who may then be entitled to vote for said Board of Directors.

9. Plan of Reorganization: It is proposed to preserve, unchanged, the capital structure of said company, and through the existing committees formed to represent the various classes of securities to obtain deposits of these securities for the purpose of modifying the terms and conditions thereof, as follows:

(A) Each of said bonds shall accrue interest at 6% per annum to January 1, 1934, and such interest shall be paid at the maturity of said bond; thereafter, and until December 31, 1938, each of said bonds shall accrue interest only at the rate of 4% per annum, and such interest shall be contingently paid in accord-

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

ance with the provisions of sub-paragraph (E) of this paragraph 9; prior to January 1, 1939, no default under said mortgage (1) in the payment of bond interest, (2) in the maintenance of sinking funds, (3) in the sale of capital assets in accordance with the provisions of sub-paragraph (F) of this paragraph, and/or (4) in the use or disbursement of insurance moneys in accordance with the provisions of sub-paragraph (G) of this paragraph, shall be enforcible; the action of the bondholders in waiving the provisions of said bonds and of said mortgage as in this sub-paragraph hereinbefore provided, shall in no way prejudice or affect the rights of said bondholders under any other provision of said bonds or said mortgage, and the bondholders, by virtue of consenting to the foregoing changes in the provisions of said bonds and said mortgage, shall not be held to have otherwise waived any rights which they may heretofore have had, now have, or hereafter have as to priority of their lien upon the assets described in said mortgage, and especially, but not exclusively, as to priority of any lien which may result from the interpretation and/or construction of the terms and provisions of paragraph "Eleventh" of said mortgage describing the properties covered by said mortgage and Section 2 of Article VIII of said mortgage; on and after January 1, 1939, all

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

provisions of said mortgage shall again be operative, and the said mortgage shall thereafter be construed, interpreted and acted upon by the trustee thereunder, and by all other parties in interest, as though no default had existed thereunder prior to January 1, 1939.

(B) Said note shall be extended to mature on January 1, 1943, and shall accrue interest at the rate of 7% per annum to January 1, 1934, to be paid at maturity of said note; said note shall accrue interest from January 1, 1934, to December 31, 1938, at the rate of 3% per annum, to be paid in accordance with the provisions of sub-paragraph (E) of this paragraph; after December 31, 1938, said note shall accrue interest at the rate of 6% per annum, to be paid in accordance with the provisions of sub-paragraph (E) of this paragraph; in the event of any default in carrying out this plan under which the holders of said bonds shall be enabled to enforce the lien of said bonds against the properties covered by said mortgage, then the same default shall mature said note and enable the holders of said note, at their option, to enforce any rights or remedies which they may have for the collection of said note.

(C) Dividends upon the First Preferred stock at the rate of $7.00 per share per annum shall accrue and accumulate to January 1, 1934, and from January 1, 1934 to December 31, 1938,

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

all dividend requirements upon said First Preferred stock shall be waived;

(D) All dividend requirements on Second Preferred stock prior to January 1, 1939, shall be waived;

(E) So long as any bonds may be outstanding, operating expenses and taxes for each year shall be paid, the plant shall be adequately maintained, and, in addition to the cost of such maintenance, the management shall provide for each calendar year sufficient "available funds" to purchase and retire $200,000.00 par value of bonds during each of the years 1934, 1935, 1936, 1937 and 1938, and $135,000.00 par value of bonds during each year subsequent to 1938.

Definitions:

1. The term "retirement fund" shall mean the depreciation charges of the company in each year as shown by the certified audit of that year, which in no event shall be less than such charges for the year 1932, to-wit, the sum of $279,404.48.

2. The term "available funds" shall mean the sum in any year of the "retirement fund" for that year and the net operating profit of that year.

The "retirement fund" of any year shall be used only for the purchase and retirement of bonds until all bonds may be retired, thereafter

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

for the payment and retirement of said note, and thereafter for the payment of accumulated and accruing dividends upon the First Preferred stock.

Interest on the bonds or note, if and when paid by order of the Board of Directors, shall only be paid out of the "available funds" produced in any year in excess of the "retirement fund"; provided that if such excess funds shall be insufficient in any year to pay 66 2/3% of the face of all bond coupons of the same date of maturity, then such excess funds as may be insufficient to pay 66 2/3% of the face of all bond coupons of equal maturity shall be held by the Board of Directors in reserve to the applied in future payment of such coupons if and when additional excess funds may be available to pay such coupons; it is intended to provide hereby that no payment in a less amount than 66 2/3% of the face value of a coupon shall be made upon any coupon which represents the accrual of bond interest from January 1, 1934, to December 31, 1938.

The amount of the "available funds" for any year in excess of the "retirement fund" for that year shall be ultimately applied by the Board of Directors as follows:

First. For paying bond interest which may have accumulated subsequent to January 1, 1934;

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

Second. For paying note interest which may have accumulated subsequent to January 1, 1934;

Third. For the purchase and retirement of bonds and note principal in the proportion of 81% par value of bonds and 19% par value of note.

After the said purchase and retirement of bonds of the par value of $1,000,000.00, then the amount of the "available funds" for any year in excess of the "retirement fund" for that year shall be applied by the Board of Directors as follows:

First. For paying bond interest which may have accumulated subsequent to January 1, 1934;

Second. For paying note interest which may have accumulated subsequent to January 1, 1934;

Third. For the purchase and retirement of bonds and note principal on a pro rata basis according to the par value of the then outstanding bonds and the face value of the then unpaid principal of said note.

Anything herein to the contrary notwithstanding, a majority of the members of the Board of Directors representing the superior then outstanding securities may, in their discretion, divert any part or all of such "available funds", inclusive of the "retirement fund",

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

to capital plant additions, capital plant improvements and/or capital plant betterments.

The management shall always maintain the current net assets of the corporation in at least the sum of $500,000.00, and failure so to do shall be a default hereunder on the part of the management.

In case of dispute between the Board of Directors and the management as to what constitutes reasonably adequate plant maintenance, the disputed question shall be submitted to the final decision of a person experienced in the operation of paper mills to be appointed by agreement of the Board of Directors and the management; in case the Board of Directors and the management cannot agree upon such appointment, then the Board of Directors shall appoint such a person, the management shall appoint such a person, and said two appointees shall appoint a third such person; the three persons so appointed shall constitute a board of arbitration, and the decision of a majority of said board shall be final and conclusive in the premises. If the said person appointed by agreement of the Board of Directors and the management, or if said board of arbitration shall find that the plant has not been reasonably adequately maintained, he or it shall further find the sum necessary to be expended to place the plant in a condition of reasonably adequate

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

maintenance; if, after deducting such sum, the management has not produced sufficient "available funds" to purchase the par value of bonds as heretofore in this paragraph provided, the Board of Directors may declare a default on the part of the management and, if such default shall not, within ninety (90) days after notice to the management thereof, be adequately cured according to the judgment of a majority of the Board of Directors representing the bondholders, then the Board of Directors shall, at the direction of a majority of the Directors representing the bondholders, discontinue the services of the management.

"(F) The management may, with the consent of the Board of Directors, call any capital assets provided that the proceeds of such sale shall be used for replacements and/or improvements to be subject to the lien of the bonds, or

First, to the purchase and retirement of all bonds;

Second, to the retirement of all of said note. Hereafter, and until December 31, 1938, regardless of any default in said mortgage as waived under sub-paragraph (A) hereof, the company may use and/or dispose of any standing timber of the company upon the purchase and delivery to the trustee under said mortgage, for cancellation, such outstanding bonds as in the aggre-

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

gate of par value shall be equal to the aggregate of stumpage value of such timber so used or disposed of; said stumpage values shall be the values as set forth in Section 2 of Article IV of said mortgage.

(G) Any and all moneys received by the company in liquidation of any claim for loss under any fire insurance policy, shall, until December 31, 1938, be applied by the company, under the direction of its Board of Directors, either in the replacement of the property destroyed, or

First, to the purchase and retirement of all bonds; and,

Second, to the retirement of all of said note.

The purchase and cancellation of bonds under the provisions of this sub-paragraph (G), and/or under sub-paragraph (F) hereof, shall not be considered as a credit to the management in determining its default hereunder.

(H) If and when bonds are to be purchased and cancelled under the terms of sub-paragraph (E) hereof, under the terms of sub-paragraph (F) hereof, and/or under the terms of sub-paragraph (G) hereof, notice thereof, published once a week for four successive weeks immediately prior to the purchase of said bonds in a newspaper of general circulation, published in each of the cities of Seattle, Portland, San Francisco and Los Angeles, shall be given

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

inviting offers for sale of bonds. Offers submitted shall be opened in the presence of the Board of Directors, and such offers may be accepted or rejected in the discretion of the Board of Directors, provided that only the lowest sale price shall be accepted.

(I) After the bonds have been fully retired, the permanent bondholders' committee shall retire.

(J) After the indebtedness to the noteholder has been fully paid, the permanent noteholder committee shall retire.

(K) Upon the declaration, payment, or setting apart of all accrued and accumulated dividends on the First Preferred stock, the permanent First Preferred stockholders' committee and the permanent Second Preferred and Common stockholders' committee shall retire.

(L) Not less than 85% of the voting trust certificates of Common stock, and not less than 85% of the Second Preferred stock shall be deposited in escrow with the Depositary to be selected by the Board of Directors; if, as and when $1,400,000.00 par value of said outstanding indebtedness, consisting of said bonds and said notes, shall have been purchased and retired under the present management, as contemplated by sub-paragraphs (E), (F) and (G) hereof, then the said Depositary shall deliver to the present management such a number

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

of shares of said Second Preferred stock and/or voting trust certificates of Common stock as shall bear the same ratio to the total number of shares of Second Preferred stock and voting trust certificates of Common stock so deposited in escrow as said amount of $1,400,000.00 of said retired indebtedness shall bear to $2,790,150.00; thereafter, the said Depositary shall annually deliver to the management such a number of shares of said Second Preferred stock and/or voting trust certificates of Common stock as shall bear the same ratio to the total number of shares of Second Preferred stock and voting trust certificates of Common stock so deposited in escrow as the amount of any annual retirement of par value of bonds and principal of note under the provisions of subparagraphs (E), (F) and (G) hereof shall bear to $2,790,150.00; provided, however, that the Second Preferred stock shall be first delivered.

Should said management so manage the affairs of the corporation that the management is unable to provide "available funds" as hereinbefore provided for the purchase and retirement of $200,000.00 par value of bonds during each of the years 1934, 1935, 1936, 1937 and 1938, and/or after 1938 shall be unable to provide for each current year a sum sufficient to purchase and retire $135,000.00 par value bonds

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

and to pay the current interest upon the outstanding bonds and note, then the said Depositary, upon written notice from the Board of Directors to the Depositary and management of such default, and upon the continuance of such default for a period of ninety (90) days after such notice, shall, at the direction of a majority of the members of the Board of Directors representing the superior then outstanding securities, either—

1. Continue to hold said Second Preferred stock and voting trust certificates of Common stock for ultimate use or disposal in the negotiation and consummation of any plan of successor management; or,

2. Deliver said Second Preferred stock and voting trust certificates of Common stock to the purchaser of the properties of the company at an execution sale held under the foreclosure of said mortgage and deed of trust.

(M) Failure to provide available funds as above provided shall give the Board of Directors authority to change the present or any future management; provided, however, if the management shall have provided available funds in excess of the requirements above stated for any one year, then in any such case such excess shall be considered as a credit to the management for any year thereafter in

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

which it may be unable to provide for such annual retirements.

(N) The "management," as that term is used in this plan, is presently the Western Cooperage Company, a corporation of Oregon, and said corporation shall, at its option, continue in said management so long as it shall not be in default hereunder; if, upon default of the management, as herein provided, the Board of Directors shall remove the management, or if the management shall resign its management, then and in either of said events the defaulting or resigning management shall have no voice in the creation of a succeeding management which shall be created solely by resolution of the then Board of Directors. If, at any time, the then existing management and the Board of Directors shall agree upon other management to be substituted for the then management, then and in that event such management as so agreed upon shall succeed to the management under this plan.

10. Effect of Default of Management: In case the management shall default in providing "available funds" as hereinbefore provided for the retirement of debt or the payment of interest or dividends, then this plan shall continue or terminate in the discretion of a majority of the members of the Board of Directors representing the superior then outstanding securities; if the Board of Directors

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

shall decide to terminate this plan; then the Second Preferred stock and voting trust certificates of Common stock shall be delivered as hereinbefore provided in case of default of the management, and all other securities deposited hereunder shall be freed from any change in terms or conditions thereof resulting by reason of deposit hereunder.

11. Procedure for Carrying Out the Plan: Security holders are requested to deposit their securities with the depositary hereinafter named, and it is recommended that the Hawley Pulp and Paper Company employ Blyth & Co., Inc., to assist in the presentation of this plan to the various classes of security holders; upon the deposit of said securities the reorganization committee will cause said depositary to issue to the depositor thereof a deposit receipt therefor; said deposited securities shall be held by said depositary until such time as such securities, in an aggregate amount of each class shall, in the opinion of the undersigned reorganization committee, be sufficient to insure the successful consummation of the plan; upon the written declaration of said committee the plan shall go into effect and the securities deposited with said depositary shall, in exchange for the deposit receipts issued therefor, be delivered to the holders of said deposit receipts with the endorsement upon said securities by reference to a recorded instrument of any change in the terms or conditions of said securities resulting from the acceptance and consummation of this plan.

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

12. Withdrawal of Offer to Security Holders: In case the security holders shall not accept this plan by deposit of their securities in such volume as to warrant the undersigned reorganization committee in a determination that this plan may be ultimately successfully consummated, then the said reorganization committee may, in its discretion, declare the termination of this plan, and thereupon any securities deposited hereunder shall, upon tender of the deposit receipts issued therefor, be returned by the depositary to the deposit receipt holders.

13. Nomination of Depositary: The Bank of California, National Association, a corporation organized and existing under the laws of the United States, is hereby designated as the depositary under this plan.

Respectfully submitted,

ISAAC D. HUNT

WATSON EASTMAN

E. S. COLLINS

A. S. KERRY

W. LAIR THOMPSON,

Reorganization Committee.

Third, Whereas, the Board of Directors of said Company has, by resolution duly adopted, approved said plan and authorized its consummation; and,

Fourth, Whereas, this reorganization indenture is executed and recorded for the purpose of definitely fixing the rights of the security holders who may

(Testimony of John H. Smith.)

Petitioner's Exhibit No. 1—(Continued)

accept said plan and deposit their securities under and pursuant thereto, and the rights of holders of deposit receipts for such securities as may be deposited under and pursuant to said plan; and

Now, Therefore, in consideration of the premises and of the mutual agreements herein contained, the parties hereto do hereby severally agree, each party agreeing with each and all the other parties hereto, as follows:

Article I.

Definitions.

The terms defined in this Article I shall, for all purposes in consummation of said plan of reorganization, have the meanings herein specified, unless the context otherwise requires:

Board of Directors: The term "Board of Directors" shall mean the Board of Directors of the Company.

Bonds: The term "bond" or "bonds" shall mean any first mortgage sinking fund 6% gold bond of the Company issued and outstanding under the original mortgage.

[Endorsed]: Filed U.S.B.T.A. Sept. 17, 1942.

By Mr. Phillips:

Q. I hand you Petitioner's Exhibit 1 and ask you if that is a copy of the reorganization indenture which was formulated (handing document to witness)?

(Testimony of John H. Smith.)

A. Yes, it is.

Q. And that indenture includes a copy of the plan of reorganization, I think it is right in front?

A. That is correct, although there is one thing that I am not positive about. That is, from the time this reorganization indenture was formulated, as in this written copy, and the time the plan was really approved by the court, [49] there might have been some slight modification. I don't know, whether that was the case, so your question of whether this is the plan as it was, I don't know but I would say it was except for some possibly,—some modification.

Q. So far as,—

A. (Interposing) But as far as that goes, I recall being back in Washington on the S.E.C. and there might have been some slight changes.

Q. But there weren't any changes you,——

A. (Interposing) I don't recall of any changes, but it seems there was a request for a modification.

Mr. Phillips: I offer that exhibit in evidence.

Mr. Tonjes: Do you recall whether there was any request for any modification with respect to the considerations the Western Cooperage Company was to receive, or was it to receive any under that plan?

The Witness: I don't recall for sure and I might make a peculiar statement, I could go ahead and explain what I have in mind.

The Member: Well, I don't think it would accomplish anything.

(Testimony of John H. Smith.)

Mr. Phillips: It would just be explanatory to bring out whether or not the Western Cooperage Company had the right to receive this stock about,—that was transferred to Mr. Smith. [50]

The Member: Well, we had better go along.

By Mr. Phillips:

Q. During 1934, what progress was made with respect to securing the various security holdings under this proposed reorganization plan?

A. In excess of the required percentage in, I think, 77B requires better than two-thirds of each class of securities to become effective and that was accomplished.

Q. And do you know that whether or not,—did you have something to do with the procuring of the consents of the security holders?

A. I did.

The Member: Now, Mr. Phillips, what are we getting at, for this? The plan for reorganization?

Mr. Phillips: Yes.

The Member: Well, I suppose it all leads up to the point where the taxpayer received something; as a part of the reorganization he receives an option. Let's move up to it now. We have had quite a lot of background, already.

Mr. Phillips: I was getting to this.

By Mr. Phillips:

Q. Now, then, in 1934, what part did you play personally in securing the consent of those security holders?

A. An active part in interviewing many of the holders.

(Testimony of John H. Smith.)

Q. Were you successful in getting a substantial amount [51] of securities under this plan of yours?

A. I was.

Q. Now, in 1934, will you state whether or not you had any conversations with Watson Eastman, relative to your services at that time?

A. I did.

Q. And what transpired with respect to that?

A. We made a verbal option, or I made a promise,—he made a promise to me, by saying that he wanted to reward my services, wanted to reward me for services that I had done in 1934, along the lines you have mentioned, with others in the conduct of the Hawley Pulp & Paper Company. And that, we made an option whereby he would reward me, made an agreement he would reward me for such services.

Q. Was that December, 1934? A. It was.

Q. And that option that was made by Watson Eastman to you was verbal? A. It was.

Q. And in connection with that option was there to be any commitment on your part on any services after 1934?

A. No. This was for services performed prior to that time.

Q. Prior to December 10, 1934?

A. Yes. [52]

Q. In fact, that option that was made had nothing to do with your subsequent connection with the Western Cooperage Company?

A. No, sir.

(Testimony of John H. Smith.)

Q. And your services as an employee of the Western Cooperage Company could be terminated at any time?

A. Yes, sir, that is right.

Q. Irrespective of the option?

A. That is right.

The Member: I don't want to object to leading questions. You don't ask him about a verbal option. That would be a little difficult thing, I think, —I think it would be better for your,——

Mr. Phillips: (Interposing) He was talking to Mr. Eastman.

The Member: Well, of course, the conversations, the promises,—or the thoughts of Mr. Eastman are not material to the issues of this case, or is it still background?

Mr. Phillips: Well, I will put the written documents in and tie them all up with 1934. I was taking them chronologically.

The Member: You mean the verbal option was——

Mr. Phillips: (Interposing) The verbal option here, they were not in existence until 1934 when the terms were reduced to writing and they will be explained. [53]

The Member: Well, you have not asked the witness to give the terms of the verbal agreement.

Mr. Phillips: No.

By Mr. Phillips:

Q. Will you state the terms of the verbal agreement, what the terms of the verbal agreement had with Mr. Eastman were?

(Testimony of John H. Smith.)

A. The terms of the verbal agreement were those as in the written agreement.

Q. Same as in the written agreement?

A. Yes.

Q. When was the written agreement provided for? A. I don't recall exactly.

Q. Well, first, let me ask you then, were the terms of the oral option communicated to the Board of Directors and did they pass a resolution on the same? A. Correct, they did.

Q. And I will hand you what purports to be the minute book of the Western Cooperage Company and ask you if that is the minute book of the Western Cooperage Company? A. It is.

Q. And does that page that I have opened there for you contain the resolution which was adopted by the Board of Directors relative to this oral option? A. It does. [54]

Mr. Phillips: We will offer the minute book in evidence, your Honor, and I would like to substitute a copy, have leave to substitute a copy which I have prepared and you have a copy of the minutes?

Mr. Tonjes: I have.

Mr. Phillips: We will substitute a copy.

The Member: Is there any objection to the copy coming in?

Mr. Tonjes: No objection to the copy.

The Member: It will be received as Petitioner's Exhibit 2.

(Minute book above referred to was marked Petitioner's Exhibit 2 and received in evidence.)

(Testimony of John H. Smith.)

PETITIONER'S EXHIBIT No. 2

Extract from records of Board of Directors at their meeting held May 4, 1937

The President then called the attention of the Board to the matter of arrangements which he had made with John H. Smith, Jr. in regard to distribution of stock of Hawley Pulp and Paper Company to which the Western Cooperage Co. might be entitled under the terms of the Reorganization Indenture of the Hawley Pulp and Paper Company and stated:

"1. As previously mentioned to individual members of the Board that upon the entry of the decree by the District Federal Court at Portland, Oregon, confirming the plan of reorganization of the Hawley Pulp and Paper Company in a 77-B proceeding he had, as President, and on behalf of the Western Cooperage Co. given to John H. Smith, in consideration of his services theretofore rendered in negotiating said plan and in bringing about the deposit of securities enabling the confirmation of said plan, an option

(a) To purchase, at a price of $1.00 per share which was the then fair market value of said stock, 3743 shares of Second Preferred Stock of the Hawley Company deposited by the Western Cooperage Co. under said plan; such option to be void unless exercised within a period of 60 days after the return of said Second Preferred stock to the Cooperage Co; if said option should be exercised by the

(Testimony of John H. Smith.)

said Smith before the return of said stock to the said Cooperage Co., the said Cooperage Co. would file with the Depositary holding said Second Preferred Stock in escrow under the terms of said reorganization plan, a written order directing the said Depositary to deliver, when the Cooperage Co. should be entitled to the return of said stock under the terms of said reorganization plan, to the said Smith said stock as purchased by him in the exercise of said option; and

(b) To purchase on or before January 1, 1940, at a price of $7437.70 the right to receive all common stock of the Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the Cooperage Co. in the performance of its management contract referred to in said plan of reorganization; because of the possibility that the Cooperage Co. may be entitled to receive only a portion of the stock placed in escrow under the said reorganization plan and not be entitled to receive all such stock by reason of management default, then, in case said Smith exercises his said option, the Depositary holding the common stock in escrow under the terms of said reorganization plan be given a written notice by the Cooperage Co. that it had sold its right to receive 74377 shares, accompanied by a written order to deliver the common stock of the Hawley Pulp and Paper Company held by them in escrow at the ratio of six shares to the Cooperage Co. and four shares to John H. Smith until the Cooperage Co. has been thus delivered 100,001 shares and John H. Smith approximately 66667

(Testimony of John H. Smith.)

shares and thenceforth deliver the balance of approximately 7710 shares held in escrow to John H. Smith; all such deliveries to be made by the Depositary when the Cooperage Co. has earned the release of stock by the Depositary as set forth in the said reorganization plan.

2. That the said Second Preferred Stock and Common Stock of the Hawley Company to be returned to and received by the Cooperage Co. under the terms of said reorganization plan has recently increased substantially in market value, and, for that reason, the said option should in fairness to all interested parties and to protect the heirs of said Smith, be recorded by formal instrument to be executed by the Cooperage Co; and

3. That he recommends the adoption of a resolution whereunder his act in giving said option would be ratified, and the executive officers of the corporation would be authorized and directed, for and on behalf of the corporation, to execute and deliver as of December 10, 1934, the date of said decree of confirmation, to said John H. Smith a formal instrument of option embodying the terms of said options aforesaid.

Whereupon, on motion duly made, seconded and unanimously carried, the following resolution was adopted:

Be It Resolved that the act of the President of this corporation on December 10, 1934, in giving to John H. Smith, in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company

(Testimony of John H. Smith.)

and in bringing about the deposit of securities enabling the confirmation of said plan by decree of the District Federal Court of Portland, Oregon, an option

[Printer's Note: In the above paragraph beginning with the words "to John H. Smith," to the end of paragraph, the matter is rung, with the word copy in longhand in the margin.]

(a) To purchase, at a price of $1.00 per share which was the then fair market value thereof, 3743 shares of Second Preferred Stock of the Hawley Pulp and Paper Company deposited by the Cooperage Co. under said plan; such option to be void unless exercised within a period of 60 days after the return of said Second Preferred Stock to the Cooperage Co; if said option should be exercised by the said Smith before the return of said stock to the said Cooperage Co. the said Cooperage Co. would file with the Depositary holding said Second Preferred Stock in escrow under the terms of said reorganization plan, a written order directing the said Depositary to deliver, when the Cooperage Co. should be entitled to the return of said stock under the terms of said reorganization plan, to the said Smith said stock as purchased by him in the exercise of said option; and

(b) To Purchase on or before January 1, 1940, at a price of $7437.70 the right to receive all common stock of the Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the Cooperage Co. in the performance of its manage-

(Testimony of John H. Smith.)

ment contract referred to in said plan of reorganization; because of the possibility that the Cooperage Co. may be entitled to receive only a portion of the stock placed in escrow under the said reorganization plan and not be entitled to receive all such stock by reason of management default, then, in case said Smith exercises his said option, the Depositary holding the common stock in escrow under the terms of said reorganization plan be given a written notice by the Cooperage Co. that it had sold its right to receive 74377 shares, accompanied by a written order to deliver the common stock of the Hawley Pulp and Paper Company held by them in escrow at the ratio of six shares to the Cooperage Co. and four shares to John H. Smith until the Cooperage Co. had been thus delivered 100,001 shares and John H. Smith approximately 66667 shares and thenceforth deliver the balance of approximately 7710 shares held in escrow to John H. Smith; all such deliveries to be made the Depositary when the Cooperage Co. has earned the release of stock by the Depositary as set forth in the said reorganization plan.

Be It Further Resolved, that the executive officers of this corporation be authorized and directed on behalf of this corporation to execute and deliver, as of the 10th day of December, 1934, to John H. Smith, a formal option substantially setting forth the option and the terms and provisions thereof as hereinbeforein this resolution recited.

[Printer's Note: In the above paragraph beginning with the words "that the executive of-

(Testimony of John H. Smith.)

ficers" to the end of the paragraph, the matter is bracketed in margin, with the notation "Copy 2" written in longhand in the margin.]

[Endorsed]: U. S. B. T. A. Filed Sept. 17, 1942.

By Mr. Phillips:

Q. Now, I will hand you, Mr. Smith, what appears to be an option agreement between the Western Cooperage Company and yourself, and ask you if that is the written agreement that was drawn up embodying the terms of the oral option which you previously had? A. It is.

Q. Now, the terms of the oral option, then, that you have referred to are the same that as the terms in this written option? A. That is right.

Mr. Phillips: We will have that marked also. You [55] have a copy of the option agreement?

Mr. Tonjes: I have a copy.

Mr. Phillips. We will offer that in evidence.

The Member: Then without objection that will be received as Petitioner's Exhibit 3.

(Whereupon the written option was marked Petitioner's Exhibit No. 3 and admitted in evidence.)

PETITIONER'S EXHIBIT No. 3

OPTION AGREEMENT

Know All Men By These Presents, that the Western Cooperage Company, a corporation, hereinafter called the "Cooperage Company", in consideration of services rendered by John H. Smith of Portland, Oregon, hereinafter called "said Smith",

(Testimony of John H. Smith.)

prior to the date hereof, in negotiating the plan of reorganization as set forth in the reorganization indenture between the Hawley Pulp and Paper Company, hereinafter called the "Hawley Company", and its depositing security holders of date January 18, 1934, and in bringing about the deposit of securities enabling the confirmation of said plan, does hereby, on this 10th day of December, 1934, grant unto the said John H. Smith, his heirs or assigns, the following several options, either one of which, or both of which, may be exercised by the said Smith, his heirs or assigns, upon compliance by him or them with the terms of the option which is being exercised by him or them; said options are expressed and conditioned as follows, to-wit:

[Printer's Note: Longhand notation in margin "Copy 1."]

Option A

1. To purchase, at the price of $1.00 per share, which is the fair market value thereof as of the date of this option, 3743 shares of the Second Preferred Stock of the Hawley Company deposited by the Cooperage Company under said plan of reorganization.

2. This option shall be void unless exercised by the said Smith, his heirs or assigns, on or before the expiration of a period of sixty (60) days after the return of said Second Preferred Stock to the Cooperage Company under and in accordance with the provisions of said reorganization plan.

3. If said option should be exercised by the said Smith before the return of said stock to the said

(Testimony of John H. Smith.)

Cooperage Company under the provisions of said plan of reorganization, the said Cooperage Company will, upon written request of said Smith, file with the Depositary holding said Second Preferred Stock in escrow under the terms of said reorganization plan a written order directing the said Depositary to deliver, when the Cooperage Company should be entitled to the return of said stock under the terms of said reorganization plan, to the said Smith, the said stock as purchased by him in the exercise of this option.

4. This option may be exercised by the said Smith, his heirs or assigns, at any time hereafter until the expiration of a sixty-day period after the return of said Second Preferred Stock to the Cooperage Company by the delivery to the Cooperage Company of his or their written declaration of the exercise of this option together with the option price ofthree thousand seven hundred forty-three Dollars (3743.00).

[Printer's Note: Written in longhand in the margin the word "Start".]

Option B.

1. To purchase on or before January 1, 1940, at a price of $7437.70, the right to receive all common stock of the Hawley Company in excess of 100,001 shares of the common stock of the Hawley Company to be received by the Cooperage Company in the performance of its management contract referred to in said plan of reorganization.

2. This option shall be void unless exercised by

(Testimony of John H. Smith.)

the said Smith, his heirs or assigns, on or before January 1, 1940.

3. It is possible that the said Smith, his heirs or assigns, may exercise this option and that the said Cooperage Company, by reason of management defaults, may be entitled to receive only a portion of the Common Stock of the Hawley Company placed in escrow under said reorganization plan, and if such be the case then the Cooperage Company will, upon such exercise of this option and upon the written request of said Smith so to do, file with the Depositary holding said Common Stock in escrow under the terms of said reorganization plan a written notice that it has sold to said Smith, his heirs or assigns, its right to receive under said reorganization plan 74,377 shares of the Common Stock of the Hawley Company, and with said writtgn notice the Cooperage Company will file with said Depositary a written order directing the said Depositary to thereafter deliver to the Cooperage Company and said Smith, his heirs or assigns, the said Common Stick of the Hawley Company held by it in escrow and which the Cooperage Company may be entitled to receive, in the proportion of six shares to the Cooperage Company and four shares to the said Smith, his heirs or assigns, until the Cooperage Company shall have received 100,001 shares and the said Smith, his heirs or assigns, shall have received approximately 66,667 shares, and thereafter to deliver the balance of said stock of approximately 7,710 shares to the said Smith, his heirs or assigns.

(Testimony of John H. Smith.)

4. In case this option shall be exercised by said Smith, his heirs or assigns, and if the Cooperage Company may have earned the release to it of said stock in accordance with the provisions set forth in said reorganization plan, then all such deliveries of said Common Stock shall be made by the said Depositary to said Cooperage Company and to said Smith, his heirs or assigns, in the proportion in the next preceding paragraph stated.

5. This option may be exercised at any time hereafter until January 1, 1940, by the delivery by said Smith, his heirs or assigns, to the Cooperage Company of his or their written declaration of the exercise of this option together with the option price of Seven thousand four hundred thirty-seven and 70/100 Dollars ($7437.70).

[Printer's Note: Longhand notation in margin "—to here."]

In Witness Whereof, the Western Cooperage Company, pursuant to a resolution of its Board of Directors, has caused this option to be executed as of the day and year first above written, by its officers as below subscribed.

WESTERN COOPERAGE COMPANY

By Watson Eastman, President

Attest: Louis Woerner, Secretary

Witnesses.

A. L. Homes

Dorothy Andrews

[Endorsed]: U. S. B. T. A. Filed Sept. 17, 1942.

(Testimony of John H. Smith.)

Mr. Phillips: And I would like to substitute a copy.

Mr. Tonjes: No objection to the copy.

The Member: All right. The copy will be marked and received in evidence.

By Mr. Phillips:

Q. This option, "A", was with reference to the second preferred stock of the Hawley Pulp & Paper Company and option "B" with reference to the common stock of the Hawley Pulp & Paper Company. Will you state whether the option "A" has anything to do with this tax matter?

A. No.

Q. That may be withdrawn,—or option "B" of the common stock is the only matter involved in this proceeding? A. That is right.

Q. Now, under the terms of this option "B" which was to be exercised prior to January 1, 1940, will you state whether or not you exercised your right to purchase under this option agreement?

[56]

A. I did.

Q. And on what date did you exercise that option to purchase?

A. I forget the exact date. It would be just prior to March 19, 1938, I would judge from the record as I have here.

Q. When you did exercise your option, did you purchase the stock referred to in the option?

A. I did.

Q. Both common and preferred?

(Testimony of John H. Smith.)

A. I did.

Mr. Tonjes: Was the option in writing, that option referred to, was that in writing?

The Witness: I don't recall.

By Mr. Phillips:

Q. I hand you your own check drawn to the Western Cooperage Company dated March 21, 1938, and ask you if that was in payment both of the common and second preferred stock under the terms of the option? A. It was.

Mr. Phillips: We offer that in evidence, check for $11,180 covering both of those. We will offer this check in evidence.

Mr. Tonjes: All right.

The Member: The check will be received in evidence as Petitioner's Exhibit 4. [57]

(Check above referred to marked Petitioner's Exhibit No. 4 and received in evidence.)

PETITIONER'S EXHIBIT No. 4

Portland, Ore., March 21st, 1938 No. 3538
The United States National Bank 24-11
Of Portland, Oregon

Pay to the Order of Western Cooperage Co. $11180.70
Eleven Thousand one hundred eighty & 70/100 .....Dollars
JOHN H. SMITH, JR.
1-2

Pay to the Order of
The United States National Bank
266 Portland, Oregon 266
Western Cooperage Co.
[Pencil marks illegible.]

[Endorsed]: U. S. B. T. A. Filed Sept. 17, 1942.

(Testimony of John H. Smith.)

The Member: What is that check?

Mr. Phillips: That is the check which Mr. Smith gave to the Western Cooperage Company in payment of the stock.

The Member: How much is it?

Mr. Phillips: It is for $11,180.70 and the check is No. 3538 and is dated March 21, 1938.

The Member: What was that for again?

Mr. Phillips: $11,180.70.

By Mr. Phillips:

Q. Now, Mr. Smith, under the terms of your option you were purchasing 74,377 shares of common stock. How much of that check was in payment of the common stock?

A. $7,437.70, I would assume, from this check, or that figure.

Q. On the common stock? A. Yes.

Q. And the balance was $3,743, was in payment of the preferred? A. That is right.

Q. Now, will you state to the Board when you actually received the stock pursuant to this delivery?

The Member: You don't mean pursuant to the delivery.

Mr. Phillips: Pursuant to the exercise of his option. [58]

A. March 19, 1938.

The Member: What stock was received?

The Witness: On that date there was a second preferred amount, which you have a record of there, and unfortunately I haven't,—the amount of shares

(Testimony of John H. Smith.)

was 3,743 shares as I recall, but I would not be sure of that figure. That was the second preferred stock.

The Member: Is that material, how much of it there was?

Mr. Phillips: No, that would not be material.

By Mr. Phillips:

Q. And how much common?

A. Well, on that sheet,—33,759 shares of the common stock.

Q. You might just tell us how much of the common you received and on what dates, that is, all in issue.

A. On February 3, 1939, I received 3,661 shares. On November 1, 1939, I received 2,680 shares. On December 28, 1939, I received 6,033 shares and on April 12, 1940, 5,210 shares. November 13, 1940, 12,146 shares. On January 8, 1941, 10,858 and one-twenty-fourth shares or a total of 74,377-1/24 shares.

Q. Now, Mr. Smith, referring back to your oral agreement of 1934, will you please state whether or not you knew or did know anything about the market values of the common stock of [59] Hawley Pulp & Paper Company in that period of time?

A. Well, I don't think they had any market value although there was some slight transactions that I have heard of that figures under 10c a share.

Q. When you and Watson Eastman had your talks relative to this oral option and made your agreement, your oral agreement for this purchase

(Testimony of John H. Smith.)

of these shares, or, at least the right to purchase the shares, was there any discussion had as to the price? A. There was.

Q. And will you tell the Board how you arrived at the price?

A. I tried to investigate to see what the market price was and as I say, I don't think there was any market price, although we found transactions and we set the option value at what we thought was in excess slightly of the market price as compared by these transactions, as indicated of these transactions.

Q. And did you have a purpose in setting the market price in excess of the market value at that time?

A. I had a purpose in doing it but I preferred to have this on the purchase basis.

Q. You had preferred to have it be a purchase rather than a gift? A. That is right. [60]

Q. And what was the general financial condition of Hawley Pulp & Paper in December of 1934?

A. Well, in 1932 they lost something in excess of a half a million dollars and in 1933, although we were in management during that year their loss was very excessive, although not to that point and because of these losses the bonds on a flat basis were selling at,—I know of one rather sizable transaction made by the United States National Bank as a flat rate of $17.50 on a hundred.

Q. First mortgage bonds? A. Yes.

(Testimony of John H. Smith.)

Q. Secured on what properties?

A. On all the properties.

Q. Including the principal mill at Oregon City?

A. Yes.

Q. Well, then underneath the bonds, what was the next indebtedness at that time?

A. A note of $500,000 with accrued interest.

Q. And do you know anything about the market values of the first preferred stock at that time?

A. The first preferred stock at that time had a market value, at that time, of approximately $2.50.

Q. And what was the approximate market value at that time of the second preferred stock?

A. I could not find any transaction, as I recall. [61]

Q. None at all? A. No.

Q. And all the transactions as you recall it on common were less than 10c a share?

A. Yes, sir.

Q. Now, after 1934, did you receive a salary as an employee of the Western Cooperage Company?

A. I did.

Q. And did you receive anything in addition to money as compensation for services in connection with your employment there? A. I did not.

Q. You did not?

A. You are referring to the Western Cooperage Company?

Q. Yes, Western Cooperage Company. You were also an employee of the Hawley Pulp & Paper Company, I think?

(Testimony of John H. Smith.)

A. Well, I also received a salary there, is what I was thinking of.

Q. Yes, you received a salary. Now, in 1938 when you received these shares from the Western Cooperage Company, what officer of the Western Cooperage Company, what office were you holding at that time? A. I was vice-president.

Q. And did the,—you were vice-president?

A. Yes. [62]

Q. Do you know whether or not the Western Cooperage Company reported upon its books any part of this stock that you received? As additional compensation to you in any way?

A. No, I know they did not.

Q. They did not report *is* as any additional compensation to you? A. No.

Q. Now, have you had occasion to sell any of this stock since you have received it, this common stock? A. I have.

Q. And when did you make sales?

A. I made sales both in the year 1940 and in the year 1941.

Q. In order to refresh your memory, if you care to do so, I will hand you your 1940 and 1941 income tax returns and ask you if you can examine those and tell as to how many shares of the common stock you sold in 1940?

Mr. Tonjes: That is objected to as being immaterial.

Mr. Phillips: If your Honor please, the purpose of this of course is to show that Mr. Smith

(Testimony of John H. Smith.)

did sell his stock in 1940 and 1941, that is, he sold a part of it, he did not sell all of it and that he took as his basis the same 10c a share which is our theory of the case and I think it is borne out. The purchase in a transaction of this kind involves the time of the sale and not the agreement and I would like to have [63] the record show the date.

Mr. Tonjes: The Respondent submits, your Honor, that the manner in which the Petitioner computed any date is in no way binding upon the Respondent; whether he is correct in using that date, is of course the question we have before the board.

The Member: Overrule the objection. You may answer the question.

Mr. Phillips: You may answer the question and tell how many shares you sold.

A. It shows sold 22,939. It is a little faint there, it might be 900 even. I will have to add it up. No, I think it was 22,939.

Q. And at what base, on what basis did you sell that stock, that is, what did you take for your cost basis? A. 10c a share.

Q. And you computed your gain on 10c a share as cost basis? A. Yes.

Q. And reported it as income and reported your tax return? A. Yes.

Q. Now, in 1941, will you state how many shares of this common stock you sold?

A. 9,000 shares.

(Testimony of John H. Smith.)

Q. And on what cost basis did you report that? [64] A. 10c a share.

Q. And on that cost basis was your income computed in return? A. It was.

Q. In profit, the difference between your cost and selling price? A. It was.

Q. And you paid a tax on that profit in 1941, for the year 1941? A. I did.

Q. Perhaps I asked you before, with respect to this option; did your future employment after 1934 depend in any way upon this option agreement?

A. It did not.

Q. Your option agreement was just the same as it was, as if it were with a stranger?

A. Yes, that is right.

Q. Now, for the purpose of the record also, will you state who the depository was under the terms of the reorganization indenture?

A. The Bank of California at Portland.

Q. I would like to offer in evidence a letter from the Western Cooperage Company addressed to the Bank of California, N. A., depository, March 18, 1938. You have seen this? A. Yes.

Mr. Phillips: And Mr. Tonjes, he has examined it, [65] the orginal, brought by a young man from the Tax Department who was here prior to the time your Honor stepped down, and I would like to offer that, which was an offer, and an order delivered to Mr. Smith, under the terms of the reorganization indenture.

Mr. Tonjes: No objection.

(Testimony of John H. Smith.)

Mr. Phillips: I would like to submit a copy and the original may be returned.

The Member: All right. The copy may be filed and the Petitioner's Exhibit 5 will be received in evidence.

(Whereupon the letter above referred was marked Petitioner's Exhibit 5 and received in evidence.)

PETITIONER'S EXHIBIT No. 5

March 18, 1938.

The Bank of California, National Association,
Depositary,
Portland, Oregon.

Attention Mr. Day:

Gentlemen:

In re: Distribution of Second Preferred Stock and Voting Trust Certificates of Common Stock under paragraph (L) of the Reorganization Indenture of the Hawley Pulp and Paper Company.

Paragraph (L) of the Reorganization Indenture of the Hawley Pulp and Paper Company of January 18, 1934, provides as follows:

"(L) Not less than 85% of the voting trust certificates of Common stock, and not less than 85% of the Second Preferred stock shall be deposited in escrow with the Depositary to be selected by the Board of Directors; if, as and when $1,400,000.00 par value of said outstand-

(Testimony of John H. Smith.)

ing indebtedness, consisting of said bonds and said notes, shall have been purchased and retired under the present management, as contemplated by subparagraphs (E), (F) and (G) hereof, then the said Depositary shall deliver to the present management such a number of shares of said Second Preferred stock and/or voting trust certificates of Common stock as shall bear the same ratio to the total number of shares of Second Preferred stock and voting trust certificates of Common stock so deposited in escrow as said amount of $1,400,000.00 of said retired indebtedness shall bear to $2,790,-150.00; thereafter, the said Depositary shall annually deliver to the management such a number of shares of said Second Preferred stock and/or voting trust certificates of Common stock as shall bear the same ratio to the total number of shares of Second Preferred stock and voting trust certificates of Common stock so deposited in escrow as the amount of any annual retirement of par value of bonds and principal of note under the provisions of sub-paragraphs (E), (F) and (G) hereof shall bear to $2,790,-150.00; provided, however, that the Second Preferred stock shall be first delivered."

As you know, the Western Cooperage Company is the "present management" referred to in the aforequoted excerpt from said reorganization indenture.

(Testimony of John H. Smith.)

As you know, the Western Cooperage Company is the "present management" referred to in the aforequoted excerpt from said reorganization indenture.

The indebtedness of $2,790,150.00 mentioned in the above quoted excerpt from said reorganization indenture is made up of the following items, as shown in paragraph "1" of the plan of reorganization as recited in said reorganization indenture:

6% First Mortgage Bonds due 7/1/46	$2,127,500.00	
Interest accrued to 1/1/34	127,650.00	$2,255,150.00
Hereinafter called "Bonds"		
7% Note due 7/1/34	500,000.00	
Interest accrued to 1/1/34	35,000.00	535,000.00
Hereinafter called "Note"		
Total		$2,790,150.00

Of said indebtedness of $2,790,150.00, the present management has retired the following:

6% First Mortgage Bonds due 7/1/46	$1,212,000.00	
Interest accrued to 1/1/34 on said bonds retired	72,720.00	
Principal of 7% Note due 7/1/34	125,000.00	
Total retirement,		$1,409,720.00

The retirement of First Mortgage Bonds and interest thereon are evidenced by your files, which will disclose that said bonds have been cancelled by you.

The evidence of the retirement of the principal of said note is evidenced by the endorsement upon said note, a photostatic copy of which note and endorsement is attached hereto.

(Testimony of John H. Smith.)

You hold in escrow under the aforequoted paragraph "(L)" of the reorganization indenture 7,487 2/3 shares of the Second Preferred stock of the Hawley Pulp and Paper Company and voting trust certificates representing 174,378 1/24 shares of Common Stock, or a total number of shares held or represented by voting trust certificates in the amount of 181,865 17/24.

Under the terms of the aforequoted paragraph "(L)" of the reorganization indenture, the Western Cooperage Company is now entitled by reason of the retirement of said indebtedness in the amount of $1,409,720.00 to receive from you such a number of shares of Second Preferred Stock and of Common stock represented by voting trust certificates as shall bear the same ratio to the total number of shares of Second Preferred stock held by you and of Common stock represented by voting trust certificates held by you, to-wit, 181,865 17/24 shares as said retired indebtedness in the amount of $1,409,720.00 may bear to said total indebtedness of $2,790,150.00, or 91,887 shares, provided that the Second Preferred stock shall be first delivered. Accordingly, the Western Cooperage Company is now entitled to receive from you all of said Second Preferred stock in the amount of 7,487 2/3 shares and Voting Trust Certificates representing 84,399 1/3 shares of Common stock of the Hawley Pulp and Paper Company.

By virtue of the exercise of an option under a

(Testimony of John H. Smith.)

contract heretofore entered into between the Western Cooperage Company and John H. Smith, the said John H. Smith is entitled to receive, out of said 7,487 2/3 shares of Second Preferred stock, 3743 shares of said Second Preferred Stock of the Hawley Pulp & Paper Company. Likewise, by virtue of the exercise of an option under a contract heretofore entered into between the Western Cooperage Company and John H. Smith, the said John H. Smith is entitled to receive, out of the voting trust certificates as aforesaid, representing 84,399 1/3 shares of the Common Stock of the Hawley Pulp and Paper Company, a voting trust certificate representing 33,759 shares of the Common Stock of the Hawley Pulp and Paper Company.

Accordingly, the Western Cooperage Company demands that you issue and deliver the Second Preferred stock of the Hawley Pulp and Paper Company and voting trust certificates representing the Common stock of the Hawley Pulp and Paper Company which it may be entitled to receive as aforesaid, as follows:

3744 2/3 shares of said Second Preferred stock to the Western Cooperage Company,

3743 shares of said Second Preferred stock to John H. Smith

Voting trust certificates representing 50,939½ shares of said Common stock of the Hawley Pulp and Paper Company to Western Cooperage Company

(Testimony of John H. Smith.)

Voting trust certificates representing 33,759 shares of said Common stock to John H. Smith.

Yours truly,

WESTERN COOPERAGE COMPANY

By WATSON EASTMAN
President

LOUIS WOERNER
Secretary

[Endorsed]: U. S. B. T. A. Filed Sept. 17, 1942.

Mr. Phillips:

Q. Now, Mr. Smith, with respect to a,—oh, there was, what was I thinking. I have here a copy of the "Oregon Voter", a list of the stock publications. All of the Hawley securities, and I was going to offer that in evidence.

Mr. Phillips: We will offer at this time, if your Honor please, the copy of the "Oregon Voter" for June 12, 1937, showing local securities. This is a publication of Portland, Oregon, and shows the range of four years on the Hawley Pulp & Paper Common stock. Also shows their preferred and common and second preferred for three years.

Mr. Tonjes: We have no objection.

The Member: It will be received as Petitioner's Exhibit 6. [66]

(Copy of "Oregon Voter" marked as Petitioner's Exhibit 6 and received in evidence.)

(Testimony of John H. Smith.)

PETITIONER'S EXHIBIT NO. 6

PORTION OF EXHIBIT #6

June 12, 1937 Oregon Voter (305) 13

LOCAL SECURITIES PRICE RANGE—4 YEARS

Bid Quotations Provided by Bond Traders' Club of Portland

Stocks	6/1/37	6/1/36	6/2/35	6/3/34
California Oregon Power 6% pfd	86	77	....	....
California Oregon Power 7% pfd	96	81	....	....
Columbia Riv Paper Mills 8% pfd	42½	33	24	10
Hawley Pulp & Paper com	6	½	¼	V
Hawley Pulp & Paper 1st 7% pfd	44	11	5	4V
Jantzen Knitting Mills com	18	11¾	8	....
Jantzen Knitting Mills pfd	95	102	97½	80xd
Mountain States Power 7% pfd	33	34	14½	7
Northwestern Electric Co. 7% pfd	74	69½	41	13
Northwestern Port Cement units	Ofd 79	53	42	42
Oregon Portland Cement com	5	2½	2½	4
Oregon Portland Cement 7% conv pfd	56	53	25	30
Oregon Portland Cement 7% cum pfd	95	90	60	50
Oregon Pulp & Paper 8% pfd	76½	44	28	15
Portland Elec Power 7% prior pfd	6	4½	2½	Ofd 3
Pacific Pow & Light Co. 7% pfd	68½	82	51½	14
Portland Gas & Coke Co. 7% pfd.	36½	29½	26	20

(Testimony of John H. Smith.)

Local Securities Price Range—4 Years—(Continued)

St Helens Pulp & Paper com	24¼	16	10	8½
U S National Bank Port ($20 pv)	39	36½	29	30
West Coast Telephone 6% pfd ($25 pv)	20	18	5½	2½
Bonds				
Arlington Club 6s	95	95	60	50
Beaver Portland Cement 7s	88	70	50	41
Columbia Riv Packers 2s '50	26f	....	....	....
Columbia River Paper Mills 6s	90	90	75	64
Hawley Pulp & Paper 6s	95f	62½f	42	33
Home Service 7s	48f	25f	45	35
Keller Boyd Building 6s	88	77	65	60
Medical Arts Building 5½s	93f	80	59	37
Morgan Bldg 6s	Ofd 12f	14f	Ofd 17	15
Mountain States Power 6s '38	93½	97	82	61
Multnomah A A Club 6s	35f	30f	25	32
Northwestern Bldg LTC 5½s	88	84	72	....
Oregon Pulp & Paper 6s	93	95	82	67
Oregon-Wash Telephone 6s '45	97	94½	85	70
Oregon Terminal 5s '45	49	51	16½	....
Pacific Properties 6s '46	47f	43f	36f	32
Pittock Block 6s	53f	40	30	35
Portland Elec Pow inc 6s '50	18f	17	15	11
Portland Pantages Building 6s	72f	43	32	Ofd 35
Portland Masonic Temple 5s	Ofd 85	90	80	....
Portland Woolen Mills 6½s	97	94	60	38
Willamette Valley Southern 6s	14f	15½	15	27½
West Coast Telephone 5s '53	95	94½	80	63

f = "flat," accrued interest disregarded; Ofd = price at which offered; xd = ex-dividend. Absence of quotations means that no satisfactory record of quotations was available.

(Testimony of John H. Smith.)

By Mr. Phillips:

Q. Now, before we leave you. Oh, yes. With respect to the San Juan Mining Syndicate, will you tell the Court when that was purchased.

The Member: Just a moment. Are you going to the next issue?

Mr. Phillips: Yes.

The Member: I would like to have the issues tried separately.

Mr. Phillips: That will be perfectly all right. I will call Mr. Smith on the latter issue.

The Member: He can be cross-examined then and I want to ask him a few questions.

Mr. Phillips: Yes, you may step down, Mr. Smith. Or, just a moment.

Mr. Tonjes: I will ask a couple of questions.

Cross Examination

By Mr. Tonjes:

Q. Mr. Smith, what was the occasion for the reduction of the agreement in 1934 to writing in 1937?

A. The Western Cooperage Corporate affairs, due to its being such a closed corporation, were carried on rather loosely. The corporation counsel was Thomas E. Warren,—I mean, Warren [67] E. Thomas. And when Mr. Thomas passed away, naturally other counsel was secured and, when the other counsel was acquainting himself with our affairs, this was one of the things he ascertained, that there was oral option and he immediately ad-

(Testimony of John H. Smith.)

vised us that that should be reduced to writing, so at the next directors' meeting the resolution was passed and a copy of which has been offered in evidence, a written copy was executed shortly thereafter.

Q. Now, in 1934, when you first got the option to buy stock of the Hawley Pulp & Paper Company, do you know whether or not the Western Cooperage Company was the owner of any shares of the common stock of the Hawley Pulp & Paper?

A. In 1934?

Q. Yes.

A. In 1934 they were not owners of common stock.

Q. Then there would have been no option you could have exercised at that time, was there?

A. The option to receive the stock,—only the stock they would be entitled to as provided for in the reorganization indenture.

Q. And in 1934 there had been no stock delivered to the Western Cooperage Company pursuant to the indenture, had there?

A. The stock in question was deposited with the Bank of California, and I don't recall the exact date, but it was prior, considerably prior to the formal code order on the indenture and [68] I rather think it was deposited sooner than January 1, 1934, but I would have to check that to be positive. I don't remember that date.

Q. Well, you mean that you, had you exercised

(Testimony of John H. Smith.)

an option immediately upon its receipt by you in 1934, you could have demanded delivery?

A. No, I could not have demanded delivery, no. Nor, would they be in a position to deliver. It was only on the fulfillment of certain,—of certain stages in the reorganization agreement that they could have delivered or I could demand.

Q. Yes. And when were the requirements met so that the Western Cooperage Company would be entitled to shares of stock of the Hawley Pulp & Paper?

A. Approximately the same dates I gave as when I acquired the stock. They did not get it all at one time. There were a number of deliveries and the dates were within a day or two of the dates listed.

Q. Was the delivery of stock as set forth in the letter of the escrow holder, the order for the first delivery?

A. That was the first delivery. I would see the order, if I may, in order to answer to be correct. (Perusing document.) Yes, that was the order for the first delivery.

Q. Then that, prior to that date, you could not have effectively exercised your option, could you? A. Oh, yes. [69]

Q. Well, how could you?

A. As I understand your question, I will put it that way, that I could have exercised my option any time between the date of the option and January, 1940. I could not have received the stock.

(Testimony of John H. Smith.)

Q. That was what I had in mind. You would not have received the stock in pursuance to the terms of the option. I will state it that way.

A. That is right.

Q. And did you report any income in 1934 on account of the receipt of this option?

A. I did not.

Q. Now, Mr. Smith, you used the expression that you would rather acquire the stock of the Hawley Pulp & Paper by purchase?

A. Yes, sir.

Q. Than any other method. A. Yes, sir.

Q. Now, the option, however, to buy the stock was given to you for services rendered, is that correct,—is it not?

A. That is correct.

Mr. Tonjes: I think that is all.

Redirect Examination

By Mr. Phillips:

Q. Again we will submit, with respect to your 1934 income [70] tax return and this option, did you consider your option of any value in 1934?

A. No, I did not, because we had probably set a price that we felt was in excess of the market.

Q. That is, the option, in and of itself was not a commodity that you could recover anything on at that time?

A. Oh, I might have been able to go out and sell it for a negligible amount, but I don't know where I would look for a sale, even.

(Testimony of John H. Smith.)

Q. It would be a very nominal amount?

A. Yes.

Q. If you did find a buyer?

A. Yes, because the option called for an option to buy the stock that was in excess of the market value of the particular stock.

Q. And the very transactions were in the stock itself? A. That is right.

Q. When you referred to services rendered as a consideration for this option, you mean services rendered during 1934 or at least prior to December 10, 1934?

A. Yes, sir. I would like to have the opportunity to elaborate there a little, if I may.

Q. I think you may.

A. You asked me on first examination whether this was for services rendered and I said yes, and you asked if these [71] services were for getting the consent of the various security holders, and I said yes. That was only part of the services. In addition, I personally was responsible to get for the Western Cooperage Company,—I forget the exact figure, but I would say,—it was virtually approximately 6,000 shares of second preferred and also to get together an additional slightly in excess of 4,000 shares in common, in addition to what the original compensation was to be to the Western Cooperage Company, what that was to be for management and it was because of that particular change that I had in mind when you asked the

(Testimony of John H. Smith.)

there was any change in that indenture and the final indenture that was accepted and I don't recall about that, I think there possibly was some little change in it but I forget the dates.

Q. What—change in the amount of securities?

A. Yes, sir.

Q. Now, did you have anything to do with the acquisition of the note?

A. Yes. I acquired the note for the Western Cooperage Company at a material discount.

Q. That is the half a million dollars referred to in the reorganization indenture?

A. That is correct.

Q. $500,000? A. That's right. [72]

Q. And you got that at a substantial discount for the Western Cooperage Company?

A. Yes, sir.

Mr. Phillips: I think that is all.

Mr. Tonjes: No further questions.

The Member: What is the Respondent's story?

The Witness: I am sorry I could not hear the question.

The Member: No, I am not speaking to you, I am speaking to Counsel for the Respondent. What is the Respondent's theory of the case?

Mr. Tonjes: The Respondent's theory is that the taxpayer received as compensation an option to buy stock, at specified price, and that he exercised that option in the taxable year and acquired part of the stock worth $2.50 for 10c and that there-

fore he realized taxable income to the extent of the difference between the option price and the fair value.

The Member: Is it agreed that the stock had a market price in 1938 and 1939 of $2.00 a share?

Mr. Phillips: I would not be too much against it if they wanted to say it was $2.00 in 1938, I don't have too much in mind on that.

The Member: So then, the amount added to taxable income between the $2.00 and the 10c is an amount I am trying to find out, is that agreeable?

[73]

Mr. Phillips: What you are interested in is the market value in 1938, isn't it?

The Member: No, it is important to know what you consider the market value to be, Mr. Phillips; you agree with Counsel's figures?

Mr. Phillips: I would not agree with their mathematics on the Commissioner's letter but I would be quite willing to stipulate with Counsel if he wants to use that value of $2.50 in 1938.

Mr. Tonjes: When I said $2.50 I meant to use the amount used by the Respondent and his deficiency.

Mr. Phillips: We also have another notice in 1939—we had a certain number of shares came in in 1939, and they did not receive those. After Mr. Smith resigned they received certain shares in 1940 and 1941 and they lumped them in its earnings.

The Member: You have checked your proof of the evidence?

Mr. Phillips: I have checked with Mr. Tonjes on the issues.

The Member: Oh, you have checked with Mr. Tonjes on the issues. Well, I want to save my questions of Mr. Smith until later. I want to check and summarize some of the figures and I can't get that now. I think I will do this now. In 1938 the Commissioner determined the income was under —[74] stated by the amount of $81,021.60. Now, that figure was the result of the following: The Commissioner said that the voting trust certificates, —I suppose that the order he received in 1938 was common stock. But the common stock received in 1938 was valued by the Commissioner at $84,397.50. Is that correct?

Mr. Tonjes: That is correct.

The Member: How many shares entered into that transfer?

Mr. Phillips: 33,759.

The Member: That number of shares were purchased in 1938, is that right?

Mr. Phillips: That number of shares were received in 1938, as being delivered to Mr. Smith.

The Member: Didn't Mr. Smith get any consideration? I thought he had an option to purchase them?

Mr. Phillips: He had an option, an entire option to purchase 74,377 shares and this 33,000 was a part of this 74,377.

The Member: I understand.

Mr. Phillips: When he exercised his option to purchase in March, 1938, by this check of $11,000

—odd dollars, one part of which was in payment of 74,377 shares. In other words, he paid for all of the shares he was entitled to receive under the option in one payment. [75]

The Member: In March, 1938?

Mr. Phillips: In March, 1938, as he has testified here when the check was offered in evidence.

The Member: All right. Then the price used by the Commissioner in computing the gain of $3375.90 is 10c a share. That is clear now.

Mr. Phillips: That is the 10c per share.

The Member: And in 1939 the balance of the stock came in to the Petitioner, is that right, the balance between 33,000-odd shares and 74,377 shares and the additional 1/24 of a share. I guess that 1/24 of a share is immaterial; no, no, that is wrong.

Mr. Phillips: No, no, that is wrong. 12,404.

Mr. Tonjes: 12,405.

Mr. Phillips: No, 12,404.

Mr. Tonjes: All right.

Mr. Phillips: 12,404.

Mr. Tonjes: Now, is it agreed he received that money in 1939?

Mr. Phillips: Yes, that is our figures, too.

The Member: Then the Commissioner determined the fair value at the time of the receipt of that stock in 1939 was $72,901.38.

Mr. Tonjes: That is correct.

The Member: And again, you don't dispute that, that [76] is, you accept that as being a fair statement of the market price, is that correct?

Mr. Phillips: I see. They are using a gradu-

ated scale during the year on the three dates of acquisition. What do you have?

Mr. Tonjes: The figures, I believe, your Honor, are for the block of 366.

The Member: No, you have that wrong; it is 3,661.

Mr. Tonjes: That is what it is, 3,661 on February 23, 1939,—$4 a share, and the next block of November 1, 1939, 2,680 shares at $6.75 and another block on December 20, 1939 of 6,063 shares and at $6.62½, making a total of $72,901.38.

Mr. Phillips: We are agreeable that the market values per share as stated by Mr. Tonjes was the market value at those particular dates.

The Member: What was the market value used for the stocks in 1938?

Mr. Tonjes: $2.50 a share in 1938.

The Member: Just one block?

Mr. Tonjes: That was for just one block.

Mr. Phillips: One block.

The Member: I think that that is all right, then.

Mr. Phillips: Did you wish to proceed to the next witness, your Honor?

The Member: Yes, I think we will just finish every- [77] thing on that issue and, just recall Mr. Smith.

Mr. Phillips: All right.

The Clerk: Will you state your name to the reporter, please.

The Witness: Cassius R. Peck.

CASSIUS R. PECK

was called as a witness for and on behalf of the Petitioner and having been first duly sworn was examined and testified as follows:

Direct Examination

By Mr. Phillips:

Q. Mr. Beck, where do you reside?

A. Portland, Oregon.

Q. What is your business or profession?

A. Attorney.

Q. And how long have you been an attorney?

A. Since 1903.

Q. In Oregon, all the time?

A. In Oregon since 1909.

Q. Now, did you have occasion to discuss with Major Eastman, or Watson Eastman, as he has been referred to, and John H. Smith with reference to the oral option that Mr. Smith has referred to in his testimony here? A. I did.

Q. You heard Mr. Smith's testimony, did you? [78]

A. I have.

Q. Will you state to the Board in that matter, first, how did it come to your attention and what transpired?

A. It was sometime in the spring of 1937, the circumstances were these: That Mr. Thomas had been counsel, general counsel and in charge of the legal affairs and corporate affairs of the Western Cooperage Company for many years. He became very ill in the spring of 1937 and while he was

(Testimony of Cassius R. Peck.)

ill, I think that he had not yet died, although his death was imminent and definite. I was called to the office of the Western Cooperage Company for a general conference with reference to the general affairs of the Western Cooperage Company and at that time the matter of this verbal option was told to me and I at that time told them that that was a matter that could not be handled in that way from a corporate standpoint. I said it would have to be authorized by a resolution of the board of directors and that must be reduced to writing and must be put in contract form in order to protect the corporation and in order to protect Mr. Smith and his heirs in case of his death.

Q. And what transpired after your suggestions to them?

A. A special meeting of the board of directors was called in, you have the record there. It runs in my mind it was early in May, 1937; and a resolution was prepared by me for the,—for submission to the Board. This was at the [79] meeting of May 4, 1937. On the basis of this, and I would say, that the first time that the matter came to my attention would probably be sometime in March. I notice that the notices calling the board meeting was sometime in April.

Q. Did you draw the resolution, the form of the resolution, the body of this agreement?

A. Yes. I drew the form of the resolution based upon what I had been told, and what was told me by Major Eastman and Mr. Smith as being the

(Testimony of Cassius R. Peck.)

basis of the oral option and having heard the testimony here, I wish to call attention to one fact: That the option "A" is a purchase of certain shares, Mr. Tonjes. Option "A". And that, the reason of the differential between the second preferred stock as contained in option "A" and the common stock as contained in option "B" is that the second preferred stock as contained in option "A" belonged to the Western Cooperage Company, and had been deposited to the Western Cooperage Company as a bond of performance under the reorganization indenture and after the reorganization indenture fell down and they did not complete the reorganization indenture, they fell down and they had an opportunity to resell; on the other hand the common stock did not belong to the Western Cooperage Company until they received it by performance of the reorganization so that option "B", you will note, provides for the purchase of the right to receive and not to purchase the actual shares. [80] Option "B", you will notice, referring to the exhibit,——

Q. That is exhibit,——

The Member (Interposing): No. 3.

By Mr. Phillips:

Q. Exhibit 3?

A. (Continuing): ——Exhibit 3, provides for the purchasing on or before January 1, 1940, the right to receive all of the common stock of the Hawley Pulp & Paper Company, in excess, and so forth; and the option also provides for contingency in

(Testimony of Cassius R. Peck.)

case the management should fall down and should not be able to receive any of the stock. So this option provided for a right to receive, as to option "A", because as to option "A", the——

Mr. Tonjes (Interposing): Your Honor, I object to this line of testimony by the witness as it is purely argumentative. The record is in the minutes and I presume they set forth what the board of directors intended.

The Member: I suppose it would be proper to have an explanation of the documents in the record. The witness is an attorney who was called in at the time the verbal option given to the taxpayer was being discussed. His answer goes beyond the question, but that is all right. Now, will you go ahead and ask the next question.

By Mr. Phillips:

Q. Now, as to Major Watson Eastman, he is not living [81] at the present time?

A. No, sir.

Q. You know approximately when he died?

A. Well, time flies pretty fast, but I would say about two years ago.

Q. About June of 1940? A. Yes.

Q. That would be right? A. Yes.

Q. Do you know anything about the market value of the stock of the Hawley Pulp & Paper Company in 1934? Did you have any contact with that?

A. Yes. I had charge of the reorganization of the Hawley Pulp & Paper Company and I was the

(Testimony of Cassius R. Peck.)

attorney for the Hawley Pulp & Paper and,—for that organization,—and I drew up the reorganization indenture, which is in evidence, and I am very much interested in the deposits of all the securities at the time, or the securities that were deposited under the reorganization indenture and, because of my familiarity with those deposits and also due to the fact that I owned some of the common stock and some of the first preferred stock myself, I did know something about the value. I would not pretend I am qualified as an expert in values.

Q. From what you know, would you say a valuation of [32] 10c would equal, or, at least, would be equal or more than equal to the market value as of December 10, 1934?

Mr. Tonjes: I object to that on the grounds that the witness is not qualified to answer that question.

Mr. Phillips: I realize that the witness' qualifications and the weight to be given is a matter for the Court to determine from Mr. Peck's experience. He has given the substance of his experience.

The Member: I will overrule the objection, but I want you to ask the witness to explain his answer.

Mr. Phillips: All right.

By Mr. Phillips:

Q. Will you kindly explain what in your opin-

(Testimony of Cassius R. Peck.)

ion the value of the stock was in 1934, and then explain your answer?

A. On December 10, 1934, I would say that the common stock of the Hawley Pulp & Paper had a market value which was something less than 10c per share. And in explanation of that answer, I would add: December 10, 1934, was the date as I recall on which the Court confirmed the plan of reorganization, and at that time I know that the bonds of the corporation, first mortgage bonds, which of course were ahead of all of the securities, of the corporation, had a market value of not to exceed $30 a share, $30 per one hundred, of par value, of face value. And I know that the first preferred stock, I know that the note of $500,000 had [83] been deposited by Mr. Smith upon a discount basis of $375,000, and under an arrangement whereby the depositor was to be paid on that note not the full amount of $500,000, but the $375,000 only, if, as and when that $375,000 might be recovered in the reorganization proceedings by making the note good. I know that the first preferred stock had a value at that time of not to exceed five or six dollars per share. And I know that the,—that there was transfers of the common stock at that time at most nominal values. I know of one transfer, and it is the only, that I actually know of, at 5c a share.

Mr. Phillips: You may examine.

Cross Examination

By Mr. Tonjes:

Q. Mr. Peck, you say that the bonds of the cor-

(Testimony of Cassius R. Peck.)

poration were selling at about $30 per hundred?

A. Yes, that is my recollection.

Q. And there was also a considerable block of preferred stock outstanding which had a priority over the common stock?

A. Oh, yes, 20,000 shares.

Q. How do you arrive at the conclusion that the common stock had a value of 10c? When, as a matter of fact, the creditors were only going to receive 30c a share, that is, I mean $30, for the shares, on their indebtedness, and then before the common stockholders could share in any of the assets [84] the preferred stockholders had to share? How do you arrive at any value at all?

A. It is most difficult to arrive at any value at all. It is most difficult, Mr. Tonjes, you have stated the reason and basis why it is most difficult to arrive at that figure. The fact is, however, that there were transfers made in 1934 at 5c a share, and please remember that I had nothing to do with the setting of this price at 10c a share. I was called in in 1937. I did not know that the price had been set. They told me then that they had put the price at 10c a share on December 10, 1934, on the date of conveyance. I can tell you something more about that now, when Mr. Smith's services were authorized, if you want me to.

Q. Then those who would buy at all would be more of a speculation, or taking a chance, would it not?

(Testimony of Cassius R. Peck.)

A. Well, it is all speculation in life that makes value.

Q. Unquestionably, though, and in your estimation, wouldn't that be the motive that would make a man buy, at all, and when I say buy, I mean that common stock?

A. I think that is true.

Mr. Tonjes: That is all.

Redirect Examination

By Mr. Phillips:

Q. As a matter of fact, what you mean in 1934 I take it, [85] the Hawley Pulp & Paper was really broke, as far as the common stock was concerned?

A. Well, in 1934, I think, the last of 1934 or the early part of 1935 there was some sales of the bonds, in the thirties. And they showed an increase, when Mr. Smith was quoted the lowest prices; early in 1934, the lowest price was $17.50, but there was some come-up in that price, some considerable come-up in the price. There was some improvement in all of the prices from the time the reorganization plan got under headway. As a matter of fact, the reorganization plan was submitted first to the S. E. C., for a ruling under the S. E. C. and the reorganization was not passed and did not come along until in June, 1934, I believe, and the S. E. C. was withdrawn, as it was felt to be as a reorganization plan, coming under 77B.

Q. Would you say the stock of the Hawley Pulp & Paper would have a considerable more value in

(Testimony of Cassius R. Peck.)

the competent hands of Mr. Smith and his assistants than without them? A. Certainly.

Q. It would have more value than the management of the directors without him?

A. Not only in Mr. Smith's hands, but in the hands of any competent man, any competent management puts value into competent industry.

The Member: Well, let us get back to the cross-[86] examination.

Q. (By Mr. Tonjes) Well, the fact is,——

Mr. Tonjes: If your Honor please, at or about the time the option was granted, Mr. Smith came in and managed the organization and by that they could expect an increase and therefore the option to buy at a later date was of far more value.

The Member: This is all argumentative and has no evidentiary value at all.

Mr. Tonjes: The testimony of this expert witness, your Honor.

The Member: Are you trying to introduce in evidence Mr. Peck or are you cross-examining Mr. Peck?

Mr. Tonjes: I am just trying to find what the effect of these things would be.

The Member: Have you any further cross-examination?

Mr. Tonjes: No, I have not.

Mr. Phillips: That is all, your Honor.

The Member: Just a moment.

Mr. Phillips: I am sorry, your Honor.

The Member: Just take a few minutes. And I

(Testimony of Cassius R. Peck.)

would like to ask you, Mr. Phillips, to have the witness point out just one or two things for me.

Mr. Phillips: Yes.

The Member: Exhibit 1 is the reorganization in- [87] denture. You have the copy, don't you?

Mr. Tonjes: I would like to have one, your Honor.

Mr. Phillips: I will ask him to furnish him with a copy in the morning. I can furnish one in the morning, and I think we have one in the office.

The Member: The stock received by the Petitioner in the taxable years was received by virtue of his exercising his option which is called option "B" in the option agreement and his Exhibit 3. Now, the opton was given to Pettioner by an officer of the corporation?

Mr. Phillips: Western Cooperage Company.

The Member: He had to have something to give an option on. The point is, a part of the reorganization agreement and tie-up to the provisions in the reorganization agreement, which gave the Cooperage Company the right to receive any of the common stock of the Hawley Company, which the Cooperage Company passed on to Mr. Smith under this optional contract.

Mr. Phillips: You are referring now to Exhibit 1 and if you want to refer to the pages and section numbers——

The Witness: On page 4.

The Member: I think I will have to ask to have my exhibit, Mr. Tonjes, my copy.

(Testimony of Cassius R. Peck.)

Mr. Tonjes: Yes. I don't see how you could follow it very well without.

The Witness: On page 4, paragraph L, there is a [88] provision under which the management receives as first, first deliveries; first deliveries on common stock, is when it shall have retired, $1,400,000 of indebtedness, which was approximately half of the indebtedness of the,——

The Member: (Interposing) Wait a minute, now. Who is the management?

The Witness: Management of the Western Cooperage Company.

The Member: Then we have to go back a little bit.

The Witness: In paragraph N of the same page——

Mr. Phillips: In paragraph N, management is divided.

The Member: Well, instead of reading the provisions of the agreement itself, tell me in your own words what the plan was. Was the Cooperage Company to take over the management of the Hawley Company under the reorganization?

The Witness: Yes.

The Member: And then were they to receive either some compensation for their managerial services or a bonus, I don't know which, in the form of stock?

The Witness: Take no compensation outside of what they received in stock in the reorganization indenture.

(Testimony of Cassius R. Peck.)

The Member: But what did they receive that stock for?

The Witness: For successful management. [89]

The Member: As compensation for management?

The Witness: Yes.

The Member: I see. And you are going back to Section L. How much was the Cooperage Company to receive from that? "After a certain time the depository shall annually deliver to the management such a number of shares of second, or of said second preferred stock and/or voting trust certificates of common stock as shall bear the same ratio to the total number of shares of second preferred stock and voting trust certificates of common stock in escrow after the amount of any annual requirement of par value bonds and principal of note under the provisions of paragraphs E, F and G hereof shall bear to the $2,790,150, and provided, however, that the second preferred stock shall be first delivered,"——

The Witness: (Interposing) Which was the outstanding indebtedness, the $2,790,150, was the outstanding indebtedness, which was outstanding ahead of the stock, ahead of the first preferred, second preferred and common stock, and the obligation was as contained in the next paragraph, was to retire in bonds, $200,000 par value bonds,—or 200,000 par value bonds, during each of the years 1934, 1935, 1936, 1937, 1938, and/or after 1938 100,000 par value until all of the bonds were to be retired. Now, after that, if they were able to do that, then

(Testimony of Cassius R. Peck.)

they received their common stock. If they did not do it and fell down on the management, then the board of [90] directors were at liberty to get some other management. That is why option "B" is a bond of right to receive.

The Member: Because you could not be sure that they, in their option, that they could exercise the option on the right to receive,—they could exercise the option on the right to receive up to January 1, 1940, and how long could the management be,—how long would it be till they could be in receipt of the stock under the reorganization?

The Witness: 1940.

The Member: That is, they should have performed?

The Witness: It would be in 1940, and they should have performed then so they had all of the stock, all of the stock would have been delivered to them had they performed.

The Member: I see now, yes. Now, then, going back to the option, Exhibit "B", Mr. Smith had the right in the option to receive all of the common stock of the Hawley Company,—"the said common stock of the Hawley Company held by it in escrow and which the Cooperage Company may be entitled to receive in the proportion of six shares to the Cooperage Company, four shares to the said Smith,—until the Cooperage Company shall have received 100,001 shares and Smith 66,667," and it is peculiar to me why that figure happened to be,——

The Witness: (Interposing) Because that was

(Testimony of Cassius R. Peck.)

the amount of stock deposited under the plan,—whatever the figure, and you say there was 200,000 of shares outstanding [91] in common stock, outstanding and the Western Cooperage Company insisted upon retaining a control. Therefore they were going to retain 100,001 shares and they were not going to let Mr. Smith have control. They only received under the plan the amount of stock that was deposited under the plan.

The Member: Well, how much was deposited?

The Witness: Well, 174,378 shares.

The Member: That is provided for in the reorganization indenture?

The Witness: Well, it is not provided——

The Member: (Interposing) Not provided, well, it is,—you can't tell how much would be deposited under the broad provisions.

The Witness: No, that is true.

The Member: That is the first time that we have gotten that detail into the record.

Mr. Phillips: That is right, your Honor.

The Member: And so, following, 174,378 shares of common of the Hawley Pulp & Paper were deposited with the depository.

The Witness: Yes.

The Member: And then under option "B" the Petitioner had the right to purchase the right to the services of 100,001 shares of that 174,378 or 74,376.

Mr. Phillips: That would be 74,377, your Honor.

[92]

(Testimony of Cassius R. Peck.)

The Member: Yes. So that explains at 10c a share the 74,377 shares, being $7437.70. So how does that tie up with what we have here now?

Mr. Phillips: That was what Mr. Smith's testimony was that was included in the check. He broke the check down into two parts.

The Member: Yes. And when Mr. Smith exercised his option the stock came to him from the depository; is that right, or from the Cooperage Company?

The Witness: Upon the notification as shown by,——

Mr. Phillips: (Interposing) The notification, exhibit, shown by Exhibit 5.

The Member: That is Exhibit 5. I see. Upon giving that notification to the depository, the depository then delivered the stock to him?

The Witness: Yes.

The Member: I see. I think it is a lot better to have the mechanics explained into the record now, rather than to wait and to have the record get cold and then have to read the exhibits and reconstruct the plan.

The Witness: Yes.

Mr. Phillips: Yes.

The Member: Well, now, I think that is all I wish to ask you, sir.

The Witness: Thank you. [93]

Mr. Phillips: Thank you; that is all then. I will call Mr. Livingstone.

(Witness excused.)

The Clerk: Will you state your name for the reporter, please?

The Witness: Colin Livingstone.

COLIN LIVINGSTONE

was called as a witness for and on behalf of the Petitioner and having been first duly sworn was examined and testified as follows:

Direct Examination

By Phillips:

Q. Mr. Livingstone, you live in Portland?

A. Yes, sir.

Q. And what is your occupation?

A. I am local manager of Blyth & Company.

Q. And what business does Blyth & Company engage in?

A. The business of securities, business of investment bankers and underwriting stocks and bonds.

Q. You do underwrite stocks and bonds?

A. Yes.

Q. For yourself and customers?

A. Yes.

Q. And how long have you been engaged in that kind of work yourself? [94]

A. I have been with the firm ever since 1919.

Q. In Portland during that time?

A. In Portland since 1920.

Q. Will you go a little further and qualify—are you, for a little further qualification, are you more or less acquainted with the background and structure of the Hawley Pulp & Paper?

(Testimony of Colin Livingstone.)

A. Quite familiar, because Blyth & Company underwrote the issue and sold in 1925 or 1926, I forget exactly.

Q. You were familiar then? A. I was.

Q. And after 1925 or 1926 did you have occasion to observe the affairs of the Hawley Pulp & Paper on the market? A. Yes, certainly.

Q. And apparently you have become quite familiar with the affairs of the Hawley Pulp & Paper Company during those years?

A. Afterwards they got in difficulty and Blyth & Company lent this company $500,000, in which transaction they received a note from the company; trying to keep the bonds from falling.

Q. That is the same note referred to in the reorganization indenture? A. Yes, sir.

Q. Are you acquainted with the values of the Hawley Pulp & Paper stocks in 1934? [95]

A. Fairly. There were not many transactions at that time.

Q. Will you state then, if you please, your familiarity with their stock structures and this loan, so far as it went; will you state what in your opinion was a fair market value of the common stock of the Hawley Pulp & Paper Company in December of 1934?

A. I would say a price of somewhere between five and ten cents a share.

Q. Would you say that 10c a share would be at least equal to or exceeding the market value?

A. It would be a fair value.

(Testimony of Colin Livingstone.)

Mr. Phillips: You may examine.

Cross examination

By Mr. Tonjes:

Q. Do you base that valuation on the basis of the assets back of the stock, that is, the stockholders' equity?

A. No, because I don't think the stock had any equity.

Q. That is speculative value?

A. Absolutely speculative, yes.

Q. Yes.

Mr. Tonjes: That is all.

Mr. Phillips: That is all.

(Witness excused.)

The Clerk: Will you state your name for the reporter, [96] please?

The Witness: M. D. Carter.

Whereupon

M. D. CARTER

was called as a witness for and on behalf of the Petitioner and having been first duly sworn was examined and testified as follows:

Direct Examination

By Mr. Phillips:

Q. Mr. Carter, you live in Portland?

A. I do.

Q. What is your occupation?

(Testimony of M. D. Carter.)

A. I am in charge here for the Western Cooperage Company.

Q. And how long have you been in charge for the Western Cooperage Company?

A. Since 1908.

Q. Are the books and records of their financial accounts kept under your supervision and direction?

A. They are.

Q. Will you,—have you examined your accounts with respect to a sale to Mr. Smith of 74,000,—no, 743,770,—or $7,437.70 of common stock of the Hawley Pulp & Paper. Will you state whether or not that was reported to the books of the Western Cooperage Company as a sale of stock in 1938.

A. You mean the sale to him? [97]

Q. Yes.

A. No. It was not recorded in the sale to him.

Q. And is it recorded as a sale?

A. Well,——

Mr. Tonjes: (Interposing) I object to the question, your Honor, as not being material. The books of the Western Cooperage Company are in no way binding upon the Respondent or this Board as to whether or not this constituted a sale at that time.

The Member: What is the purpose of that question?

Mr. Phillips: The purpose of the question, your Honor, is that in 1938 the Western Cooperage Company made this transfer of the right to receive to Mr. Smith, at least by an actual option, by virtue of receiving the money from Mr. Smith of this

(Testimony of M. D. Carter.)

74,000-odd and it is a theory of the Government that is income received by Mr. Smith during 1938 and 1939 and I want to further follow these questions to show that there was no increase in the operation expense by reason of this amount or a deduction on their income tax returns by reason of compensation paid to Mr. Smith in connection with this and they have been audited by the Internal Revenue agents or the representatives of the Internal Revenue Department and no deduction,—if their theory is correct, there is none for income in 1939 or 1938 to Mr. Smith for services. On the other hand the Western Cooperage Company would be entitled to a further [98] deduction by reason of operating expense and if your Honor please, we want to show, I mean, they have audited the books——

The Member: (Interposing) Well, it is argumentative. I will overrule the objection.

The Witness: I don't understand the question.

The Member: I think it ought to be reframed.

Mr. Phillips: Well, probably it would be better.

By Mr. Phillips:

Q. Did your books reflect receipt of money from Mr. Smith in 1938 in payment of common and second preferred stock? A. They did.

Q. And in the year 1938 was there any reflection in the records of the Western Cooperage Company of any income or salary or compensation paid to Mr. Smith which in any way reflected the value,—

(Testimony of M. D. Carter.)

market value, or any other value of this common and second preferred stock? A. No.

Q. Was there any deduction taken in any way in their income tax return for 1938 or 1939?

A. There was not.

Q. Representing any form of compensation to Mr. Smith by reason of his purchase of this stock?

A. No, there was not.

Q. Were your returns audited by the Income Tax Unit for 1938 and 1939? [99] A. Yes, sir.

Q. Now, just one other question. This amount of money that you received for this second preferred and the common stock, including $7434.70, which you received, and common stock, was that included and reflected in your income for the year 1938, if any part of it was income to the Western Cooperage Company?

Mr. Tonjes: You mean 1938?

Mr. Phillips: Yes, that is when they received it.

The Member: Read the question, please.

Mr. Tonjes: Yes, will you read that, please?

(Question read.)

The Member: Wait a minute, now. Let us reframe that whole question. You are referring to the 11,000-odd dollars, aren't you?

Mr. Phillips: Well, I will reframe the question and,——

By Mr. Phillips:

Q. Will you state whether or not the amount of money which you received from John H. Smith in 1938 in payment of the common stock was reflected

(Testimony of M. D. Carter.)

in the income of the Western Cooperage Company and if any part of it was income, was it returned as income? A. Yes.

Mr. Phillips: I think that is all I have. [100]

Mr. Tonjes: No questions.

The Member: Well, now, I wonder if the witness could answer a few questions that might be a little difficult to answer without the books.

Mr. Phillips: I will find out.

By Mr. Phillips:

Q. Do you have your books with you?

A. No, I have not. I have the journal entries on the right to receive.

The Member: Well, before I ask the questions, I will discuss the problem with counsel. I don't know just how the question in this case will finally have to be analyzed, but the Respondent's position, of course, is that the Petitioner received some compensation from the Cooperage Company when he received stock, which had a fair market value in excess of the consideration that he was to pay for it. We understand that, I believe. Now it occurs to me that from an accounting standpoint it is along the same thought that you had a few minutes ago, if Mr. Hawley received.——

Mr. Phillips: (Interposing) Mr. Smith, you mean.

The Member: (Continuing) ——if Mr. Smith received compensation in 1938 in the amount of the difference of the market price and the considera-

(Testimony of M. D. Carter.)

tion that he gave, which is a pretty large amount in 1938, the 74,000-odd dollars, the Cooperage Company had to, in some way, turn over something to [101] him that was carried on their books which would in some way or other carry a bookkeeping entry of that amount. Now, supposing Mr. Smith had performed, we will take another kind of a case, a hypothetical case, and supposing Mr. Smith had performed some unusual services for the Cooperage Company and it had been agreed that he would receive some compensation for those services in stock of the Cooperage Company, in treasury stock of the Cooperage Company. Now, that stock would be carried on the books of the company, wouldn't it? It would be carried on some value on the books of the company. Now, this question does come up in some cases where an employee is paid in stock of the company he is working for. The company may have acquired its own stock at an earlier date, at a lower price than it was issued at the time it was given to the employee, or it may be agreed that the stock be given to the employee at a reduction price.

Mr. Phillips: At a reduction price, and then you have compensation,——

The Member: (Interposing) Then how near is this case from that one or how far away is it? Now, to get at that I would like to know and, this is all preliminary to asking this accountant to give us the answer, how was the Hawley stock carried on the books of the Petitioner if it was at all?

(Testimony of M. D. Carter.)

Mr. Phillips: You mean of Petitioner's?

The Member: No, on the books of the Cooperage Company, [102] if it was carried on the books of the Cooperage Company at all. The point I want to be sure about is this: Now, the circumstance under which the Cooperage Company was to receive this stock was rather unusual. Cooperage Company went in as a new manager under a plan of reorganization. The Cooperage Company was not an owner of this stock. It did not acquire the stock or anything like that. The way in which the Cooperage Company got the stock is purely for the,—in the reorganization agreement. It is fully set forth in the reorganization agreement and after all the reorganization and the Cooperage Company had acquired the stock in the company, how was that stock carried on the books of the Cooperage Company; and then when we get that information there is to be a bookkeeping entry when that stock was transferred from the Cooperage Company to the Petitioner.

Mr. Phillips: Of course, they did not actually receive the stock, the receipt of the stock and the transfer to Smith, as far as the transfer that took place, that took place at the same time the authorization for the depository to make the transfer took place, all at the same time. And they received,—what they received was compensation to the Western Cooperage Company.

The Member: What did he receive?

(Testimony of M. D. Carter.)

Mr. Phillips: As management. They received the 100,001 shares. [103]

The Member: The Cooperage Company received 100,001 shares?

Mr. Phillips: That is what I had reference to in the 174,378 shares.

The Member: Well, they received that as compensation for their management services.

Mr. Phillips: Yes.

The Member: If they had not made this agreement with Petitioner they would have received all of the stock, or the 174,378 shares, is that right?

Mr. Phillips: Yes, but they agreed to sell it and made their agreement with Mr. Smith on December 10, 1934, at the then market value or in excess of the then market value, and that is what distinguishes this case from the case you have referred to, where a corporation actually sells outright to an individual stock at a reduced value because it is in compensation for some service. Now, that is compensation received by an employee. Now, Mr. Smith received what you might call a negligible compensation by receiving these,—or this option. Nobody at that time knew whether it had any value or not. We,—certainly, nobody placed any value on it. It was just a pure gamble, you might say, from then on, from then on out, but that is what he received in stock, just the option, an opportunity to buy the stock at what was then in excess of a fair market value; and when you have a contract [104] like that; it is just the same as if

(Testimony of M. D. Carter.)

you made it with a pure stranger, because the question of an employee goes out of the picture, it is just an instrument and I,——

The Member: (Interposing) The price was fixed.

Mr. Phillips: (Continuing) The price was fixed and he had the rights to purchase under the terms of that option, just the same as if it were made with a pure stranger; and that is the distinction, as you take where they have held there have been compensations, or direct dealings for services, and there have been many of those cases, but the option cases are different and two of them went to the Circuit Court and we will give your Honor the benefit of those cases and several of the Board members have distinguished the options.

The Member: Well, then I suppose there really is some point to be given,—some consideration probably has to be given to the particular way in which this agreement was worded and if, as counsel has pointed out, whether or not the option was to purchase Cooperage's right to receive certain common stock,——

Mr. Phillips: (Interposing) Yes, well, and——

The Member: (Interposing, continuing) It was not,—under the strict wording of the option, the contract did not give Mr. Smith the right to purchase a certain amount of the Hawley Cooperage common stock from the,—or I mean the Hawley Pulp & Paper common stock from the Cooperage Company [105] at a certain price?

Mr. Phillips: No.

(Testimony of M. D. Carter.)

The Member: If the contract had been in those terms, then Mr.,—well, I don't know whether it would make any difference in this case or not. Mr. Smith would be buying something for a fixed consideration.

Mr. Phillips: For a fixed consideration, yes.

The Member: Which, at the time, the property might have a value greatly in excess of the consideration.

Mr. Phillips: And of course that would go to his heirs and assigns in 1937, he could assign this agreement,—or contract to purchase and he would have the same consideration and he would have the right to buy under the same terms, whether he were an employee of the Cooperage Company or not.

The Member: Well, there is quite a lot of discussion on the record, but it clarifies somewhat the record to me, I believe. Now, about getting back to the question of the witness to be asked. I suppose my question would not be proper now because the Cooperage Company would not have carried an account on its own books,——

The Witness: (Interposing) Well, if your Honor please, I have a copy of my entry and if I may get it in——

The Member: Well, just let me ask a question. Will you describe what kind of entries were made in the books of the Cooperage Company, describe the transaction between the [106] Cooperage Company and Mr. Smith. That is, the receipt from Mr. Smith, by him, from the company, and the

(Testimony of M. D. Carter.)

transfer of something,—of something from Smith. Now, it is at that point that I wonder what kind of an entry you would make on your books to show what receipt of money from Mr. Smith, what would be the offsetting entry against that, what about that?

The Witness: When Mr. Smith gave us a check, of course, we made a debit to cash account and credited an account which we called John H. Smith Investment, until he should exercise his option.

The Member: What did you call it?

The Witness: John H. Smith Investment. We did not give him anything yet, in other words, he had put this money up to exercise an option. Well, a short time later, he got the stock and we paid off that again and it was simply an expense account until this happened. Then, we paid off this account and I made two entries, one debited to John H. Smith Investment Account and profit and loss credit, $7437.70, that is, for the right to receive sold to John H. Smith for the said right to receive certain stock of the Hawley Pulp & Paper and, that is, 74,277 common shares of the same and that was the entry for that, where I got that.

The Member: Well, I don't understand that very well, and I think you ought to put that in evidence. There seems to be a pretty good entry showing the descriptions of the terms [107] of their,—over the option.

Mr. Phillips: I am perfectly willing to put it in evidence, if Counsel has no objection.

(Testimony of M. D. Carter.)

The Witness: Is that all?

Mr. Tonjes: Well, if your Honor please, I think we ought to have all the records in here if we are going to have any portion, they are not complete, and unless they are complete it will be misleading.

The Member: What do you mean, they are not complete?

Mr. Tonjes: Well, I mean,—what I mean is this, when the Western Cooperage received stock of the Hawley,——

The Member: (Interposing) It never did.

Mr. Tonjes: Oh, I think it did, your Honor.

The Witness: It did not receive that.

Mr. Tonjes: Not the shares that Mr. Smith got, but it received shares under the management contract.

The Member: Well, now, Mr. Tonjes, that is just exactly why I have been having this discussion with Counsel for Petitioner, I want the record to be perfectly clear on the point.

Mr. Tonjes: So do we, your Honor.

The Member: Whether or not the stock that Mr. Smith received was received from the Cooperage Company. Now, the records so far I believe fairly show that the Cooperage Company was entitled to receive directly under the management contract [108] after the option agreement was made with Mr. Smith 100,001 shares of common stock, that was to go directly to the Cooperage Company from the depository, which was from the California Bank, the Bank of California.

(Testimony of M. D. Carter.)

Mr. Tonjes: I think that is right.

The Member: Now, the Cooperage Company was never to receive stock in excess of 100,001 shares, unless Mr. Smith failed to exercise his option.

Mr. Tonjes: That is correct.

The Member: So that the depository would retain the excess stock up to the end of the option period, or January 1, 1940. Prior to January 1, 1940, Mr. Smith exercised the option; gave notice to the depository and the depository delivered the stock that we are concerned with here directly to Mr. Smith.

Mr. Tonjes: That is correct.

The Member: That stock never went to Western Cooperage Company.

Mr. Tonjes: That is correct.

The Member: Now, that bookkeeping entry, if I may see that,——

Mr. Tonjes: (Hands document to member.)

The Member: (Continuing) ——is a journal record and as I understand it, this describes the only places where other entries were made to cover the transaction. That is, [109] the other entries to be made here in the,—were in the profit and loss account only. Profit and loss account and John H. Smith Investment. These were the only entries that could be made.

Mr. Tonjes: No, your Honor, more entries should be made and were made. The Cooperage

(Testimony of M. D. Carter.)

Company received for its own use 50,539-1/24 shares which it reported as income.

Mr. Phillips: That is right.

Mr. Tonjes: And that is a proper entry. Now, had it entered, had it not entered into this contract with Mr. Smith it would have been entitled to receive the 166,000, which it reports, plus the value of the shares that were given to Mr. Smith, but not having reported them,——

The Member: (Interposing) Well, I don't know where you are getting this information.

Mr. Phillips: That is the,——

The Member: (Interposing) Just a minute.

Mr. Phillips: Excuse me.

The Member: Where do you get that information, Mr. Tonjes?

Mr. Tonjes: You stated that there were not more entries that were necessary. I am pointing out that more are necessary to reflect the entire transaction.

The Member: Now, I am trying a case and am trying to make a record. Now, if I,—everything I have said into [110] the record is a summary of the evidence that is into the record. Now, you are talking about a lot of things, and where did you get your information?

Mr. Tonjes: You asked about the necessary entries and,——

The Member: (Interposing) Would you mind telling me where you got all this from?

Mr. Tonjes: From the testimony introduced that

(Testimony of M. D. Carter.)

the,—or to the effect that the Western Cooperage Company received in 1938 the shares from the depository at the same time that Mr. Smith received his.

The Member: Just a moment, please. Off the record.

(Discussion off the record.)

The Member: In 1938 the Bank of California, depository, was instructed by the Western Cooperage Company to deliver following trust certificates representing 50,339-1/24 common stock of Hawley Pulp & Paper to the Western Cooperage Company. That is, to itself. And to deliver to Mr. Smith 33,769 shares. Now, do you recall what kind of an account was carried on the books of the Cooperage Company to reflect its receipt or right to receive the Hawley Company stock under the plan of reorganization?

The Witness: Yes. I charged the stock that we got in 1938 to stock in other companies,—in the Western Cooperage, I mean, $50,000, 50,000-odd shares. The other, [111] we did not receive and I understand we had no right to receive it because we had sold the right to receive it, so we did not record the stock Mr. Smith received, and had we recorded it on our books we would have had a straight-out sale, and then we would have reflected the difference, or, as a loss, between the fair market value and the ten cents a share.

The Member: Well, you don't need to go beyond my question. I did not want to know why

(Testimony of M. D. Carter.)

you had done it, I will ask you another question as to that. Now, would your explanation, Mr. Phillips, that this journal entry that we were discussing a few minutes ago being charges to profit and loss accounts and the John H. Smith investment account and whatever account was kept to show the receipt of stock from the depository, would constitute the entire bookkeeping record?

Mr. Phillips: Yes, that would be,—that is, that would be a reflection in the profit and loss account and of course the other question, on the other hand, I asked, I believe, but there was no deduction in their tax return by reason of deduction, or compensation, of this tax, for Mr. Smith. But the item does not go in as an operating expenses of the company, if it was compensation.——

Mr. Tonjes: (Interposing) As a matter of fact, the effect was the same.

The Member: Well, just a moment. Let me see if I can get this straight. After the company,—if they treated [112] the transaction as a sale of an intangible right, then they must have made an entry to show they had an asset to receive some intangible right. Wouldn't they? How did they set up the intan—you pointed out that for purposes of your bookkeeping entries a sale had been made to Mr. Smith of the right to receive a certain amount of stock. That intangible right. Now, how did you set that right up as an asset on your books?

The Witness: I did not make any entry recording of our right to receive at the beginning of the

(Testimony of M. D. Carter.)

reorganization indenture. There was nothing made on my books until something transpired.

The Member: There is no receipt,——

The Witness: (Interposing) Or there had been received the stock of the Bank of California.

The Member: Then when did you receive Mr. Smith's check? When you did, you then carried some tangible account,—$7437.37, which was the exact amount of his check?

Mr. Phillips: No, that is,——

The Witness: (Interposing) We showed that, and the one percent profit, and put it in our profits; we sold something that cost nothing, as far as the books were concerned.

The Member: As far as the books were concerned?

The Witness: Yes, sir.

As far as the books were concerned; so we have nothing [113] to do except take that into our profits.

The Member: That's right. Well, I am not a very good accountant and I wanted you to explain that.

Mr. Phillips: May I explain the income or compensation, the income on compensation that the Western Cooperage Company received in 1938 for management. 50,939½ shares of common stock, plus $7437.70, that was their compensation that was received for management during that year.

The Member: Well, I think that explains it. I

(Testimony of M. D. Carter.)

would like to have that in evidence, if you would offer it.

Mr. Phillips: We will offer it in evidence.

The Member: If you can have another copy made.

Mr. Phillips: I think I can make a couple of copies and we can have them tomorrow.

The Member: Well, that will be received in evidence as Petitioner's Exhibit 7.

(Whereupon the document above referred to was marked Petitioner's Exhibit 7 and received in evidence.)

PETITIONER'S EXHIBIT No. 7

[Pencil Notations on face of exhibit]: 100 001 — 66667
Mar 21 '38—Sp. Ledger Cr. 11180.70 Red #1
Cr JHS Invest. 2nd 7487 2/3

JOURNAL 1938 216

December 12, 1938

John H. Smith—Inv. 7,437.70
Profit & Loss—1938 ..... 7,437.70

Sold to John H. Smith certain Intangibles consisting of our right to receive certain stock of Hawley Pulp and Paper Co.—ie 74377 shares common stock (See minute Records Book 5, Page 201).

John H. Smith—Investment 3,743.00
Stock in Other Companies 3,743.00

3743 shares of Hawley Pulp and Paper Co. 2nd Preferred Stock sold to John H. Smith under option (See Minute Book No. 5, page 200).

[Endorsed]: Filed U.S.B.T.A., Sept. 17, 1942.

(Testimony of M. D. Carter.)

Mr. Tonjes: Is that all?

The Member: That is all I have.

Mr. Phillips: That is all.

Cross Examination

By Mr. Tonjes:

Q. Did you make any entry on your books of account in 1938 recording the receipt of any of the stocks which were de- [114] livered to Mr. Smith from the depository? A. No.

Q. You recorded the amount which was received by the company at $2.50 a share? A. I did.

Mr. Tonjes: That is all.

Mr. Phillips: That is all. That completes our testimony on the first issue and if your Honor please, if you like, I would call Mr. Smith back on the little issue of the San Juan Mining Corporation.

The Member: Well, let us take a recess.

(Short recess.)

The Member: I might say for the record that I think that when the Revenue agent, in auditing the returns of the Cooperage Company, saw the entry on the books of the ,—reflecting the receipt of the 30,000-odd shares, which the Cooperage Company is entitled to receive from the depository at $2.50 a share. I suppose the delivery immediately started, you see, at least, the stock that Mr. Smith had received. I think the question in the case still may turn on just exactly what did Mr. Smith receive, what did his contract with the Cooperage

Company amount to? Did he purchase the right to receive the stock or did he receive?

Mr. Phillips: Well, I probably should have brought the Cooperage Company returns. [115]

Mr. Tonjes: I have the returns.

Mr. Phillips: As I recall, he had a description of the whole thing in it, of the option, and everything else.

Mr. Tonjes: I have the returns, the return of Mr. Smith and these returns, and we are on the record now, are we, your Honor?

The Member: Yes.

Mr. Tonjes: I have the returns.

The Member: Well, I think probably, Mr. Tonjes, the Cooperage Company return ought to be in evidence. Only, for the purpose of showing the whole transaction, not for anything else than the return.

Mr. Phillips: Well, most of the return would not be relevant to the issue anyway.

The Member: No.

Mr. Phillips: And it also reports here in schedule E the entire extract of the minutes of the corporation, the entire resolution we have in full, of the 1938 return.

Mr. Tonjes: You want to put them all in evidence?

Mr. Phillips: Well, that would be the part that would be the most material, because they show the sale of their right to receive the 74,377 shares and show that item in their—as a gain.

Mr. Tonjes: Yes. They report the 70,000-odd, no question about that. [116]

Mr. Phillips: Yes, and they report the whole resolution on the option.

The Member: Well, I think you better put the return in evidence.

Mr. Phillips: We are quite willing to put the return in evidence.

The Member: Respondent will have to offer it, I think, because it is their return.

Mr. Phillips: Yes, it is their return.

Mr. Tonjes: Respondent offers in evidence the income tax return of the Western Cooperage Company for the year 1938.

The Member: That is received as Respondent's Exhibit A with leave to withdraw the return and substitute photostat copies of so much thereof as is material.

Mr. Phillips: Yes. I understood it was to be received,—only those portions as are material.

Mr. Tonjes: Yes. And we have the 1939 return; we should like to offer this.

The Member: I should like to ask for a little bit more enlightenment on this. I have been trying to follow the evidence as closely as I can and make some notes, now, and I understand it was in 1938 that Mr. Smith gave his check for $11,180.70 to the Cooperage Company.

Mr. Phillips: That is right, your Honor.

The Member: And that was, of that was $7,437.70. [117]

Mr. Phillips: That is right.

The Member: With the right to receive 74,377 shares of stock.

Mr. Phillips: Common stock.

The Member: Common stock, and in 1938 the Cooperage Company directed the depository to deliver to Mr. Smith out of everything he is entitled to receive, I suppose, that would be 73,579 shares of common stock; now, in 1939, the next taxable year, Mr. Smith received some 12,000 shares more of common stock, but in 1939 the Cooperage Company did not receive any consideration from Mr. Smith and so it would not have anything in its return to,—would not have to show anything in its return in the income. So I can't see where the 1939 return is material.

Mr. Phillips: Well, I don't think the 1939 return is material at all as far as we are concerned with the issues here.

Mr. Tonjes: It would show, your Honor, that the Western Cooperage Company did not report any more than the amount that it had gotten in, —that is to say, the amount to which it was entitled for its management, less the amount it had previously sold to Mr. Smith. I think that is material. In other words, the company,——

The Member: (Interposing) Well, that can be stipulated. [118]

Mr. Tonjes: If Counsel will stipulate it, I will gladly do so.

Mr. Phillips: Yes, we will stipulate that.

Mr. Tonjes: That is satisfactory.

SCHEDULE E FROM INCOME TAX RETURN OF WESTERN COOPERAGE CO. FOR 1939

Western Cooperage Co.
Portland, Oregon
1938

Schedule "E" for Line 13, Page 1—

CAPITAL GAINS AND LOSSES

Description of Property	Date Acquired	Gross Sales Price	Cost or Other Basis	Gain or Loss
Seattle Orpheum Bonds	12/ 7/27	6,209.70	15,000.00	8,790.30
Hawley Pulp and Paper Co. Bonds	1/30/28	1,821.31	2,020.00	198.69
" "	12/29/37	150,051.40	150,051.40	—
" "	1/24/38	34,765.25	34,765.25	—
Sale of our right to receive 74377 Shares Common Stock of Hawley Pulp and Paper Company	1934 to 1938	7,437.70	*Nil	7,437.70
				1,551.29

*Under reorganization of Hawley Pulp and Paper Company we earn right to receive certain stock. Right to receive 74,377 shares sold for cash.

Extract from minutes of special meeting of the Board of Directors of the Western Cooperage Co., held on May 4, 1937:

"Be It Resolved that the act of the President of this corporation on December 10, 1934, in giving to John H. Smith, in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company and in bringing about the deposit of securities enabling the confirmation of said plan by decree of the District Federal Court of Portland, Oregon, an option

"(a) To purchase, at a price of $1.00 per share which was the then fair market value thereof, 3743 shares of Second Preferred Stock of the Hawley Pulp and Paper Company deposited by the Cooperage Co. under said plan; such option to be void unless exercised within a period of 60 days after the return of said Second Preferred Stock to the Cooperage Co; if said option should be exercised by the said Smith before the return of said stock to the said Cooperage Co. the said Cooperage Co. would file with the Depositary holding said Second Preferred Stock in escrow under the terms of said reorganization plan, a written order directing the said Depositary to deliver, when the Cooperage Co. should be entitled to the return of said stock under the terms of said reorganization plan, to the said Smith said stock as purchased by him in the exercise of said option; and

"(b) To purchase on or before January 1, 1940, at a price of $7437.70 the right to receive all common stock of the Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the Cooperage Co. in the performance of its management contract referred to in said plan of reorganization; because of the possibility that the Cooperage Co. may be entitled to receive only a portion of the stock placed in escrow under the said reorganization plan and not be entitled to receive all such stock by reason of management default, then, in case said Smith exercises his said option, the Depositary holding the common stock in escrow under the terms of said reorganization plan be given

a written notice by the Cooperage Co. that it had sold its right to receive 74377 shares, accompanied by a written order to deliver the common stock of the Hawley Pulp and Paper Company held by them in escrow at the ratio of six shares to the Cooperage Co. and four shares to John H. Smith until the Cooperage Co. had been thus delivered 100,001 shares and John H. Smith approximately 66667 shares and thenceforth deliver the balance of approximately 7710 shares held in escrow to John H. Smith; all such deliveries to be made by the Depositary when the Cooperage Co. has earned the release of stock by the Depositary as set forth in the said reorganization plan.

"Be It Further Resolved that the executive officers of this corporation be authorized and directed on behalf of this corporation to execute and deliver, as of the 10th day of December, 1934, to John H. Smith, a formal option substantially setting forth the option and the terms and provisions thereof as hereinbefore in this resolution recited."

The Option Referred to Above Was Exercised by Mr. John H. Smith March 31, 1938 and Cash Paid as Provided in the Option.

The Member: Well, then we can go on to the next issue if you are satisfied.

Mr. Tonjes: The only point is, your Honor, because Counsel earlier made some remarks the corporation did not get the benefits of this, because of deduction.

The Member: Well, that was an argument that Counsel for Petitioner was making. It had no probative value. It was not a matter of evidence. He can make that answer in a brief, you can answer, and if it is in the record you can take care of it then.

Mr. Tonjes: Very well. I did not presume that Counsel would make the remark unless he believed it to be a fact. It was not the fact.

Mr. Phillips: There was not in the accounts posted to show there was no additional compensation to Mr. Smith by reason of this option in 1938, or that there was any deduction taken by way of salary by reason of this compensation to Mr. Smith in 1938, and that is all I wanted to show.

Mr. Tonjes: I see.

Mr. Phillips: I will call Mr. Smith again.

Whereupon, [119]

JOHN H. SMITH

was recalled as a witness on his own behalf, being previously duly sworn, and testified further as follows:

Redirect Examination

By Mr. Phillips:

Q. Mr. Smith, with respect to the San Juan Syndicate, Mining Syndicate, will you explain to the Board when you purchased an interest in that Syndicate?

A. That is such a small transaction I would have to refer to something.

Q. Well, you took a loss for it on your 1939

(Testimony of John H. Smith.)

income tax return; to refresh your memory, I will hand you a copy of your 1939 return if that is of assistance to you. I think under Schedule F you will find a notation with respect to Schedule F on page 2 of the yellow or green sheet.

A. I don't keep,—I see the entry here was evidently purchased on July 17, 1937, and I have no reason to question it.

Q. Well, what I meant, did you have invested in the San Juan Mining Syndicate, how much?

A. $1,000.

Q. And who was the chairman of the San Juan Mining Syndicate? A. Paul C. Bates.

Q. And did you receive information from Mr. Paul C. [120] Bates in 1939 relative to the dissolution of this syndicate? A. I did.

Q. In the purchase of this,—let me say, did you actually pay a thousand dollars for your interest in the syndicate?

A. Yes, I paid a thousand dollars.

Q. I will hand you a letter from Mr. Bates, chairman of the San Juan Mining Syndicate in 1939, and one attached, addressed,—Dated April 6, 1939, addressed to Mr. Getchell of Idaho, and is that the signature of Mr. Bates (indicating document to witness)? A. It is.

Q. Are you familiar with his signature?

A. I am.

Q. And was 1939 the first time that you were advised that that corporation,—or, rather, the San

(Testimony of John H. Smith.)

Juan Mining Syndicate was being dissolved?

A. That is correct.

Mr. Phillips: We will offer in evidence these letters; any objection?

The Member: Is there any objection?

Mr. Tonjes. No objection.

The Member: Received as Petitioner's Exhibit 8.

(Letter referred to marked Petitioner's Exhibit 8 and received in evidence.) [121]

Mr. Phillips: That is addressed to the members of the San Juan Mining Syndicate and,——

By Mr. Phillips:

Q. Did you receive any money or profit of any kind whatsoever by reason of the liquidation of this syndicate? A. Never did.

Q. Never did? A. No.

Q. As far as you know it is washed up and done? A. That is right.

Q. And you have been so advised by Mr. Paul C. Bates by letter? A. That is correct.

Mr. Phillips: You may examine.

Recross Examination

By Mr. Tonjes:

Q. Mr. Counsel,—it is stated on the record the exact date of the purchase. Yes, he stated it as July 17, 1937.

Mr. Phillips: Yes.

A. Yes.

Mr. Tonjes: That is all.

The Member: I don't understand the Peti-

(Testimony of John H. Smith.)

tioner's position with respect to this item. The Commissioner does not question the Petitioner sustained a loss, but the Respondent has limited the loss under the capital gains and [122] loss provision of the statute. He allowed the taxpayer a deduction of $500.

Mr. Phillips: They attempt to limit his loss to 50% or $500. He claims, whatever,—he is entitled to $666.66 and we are claiming in our petition we are entitled to an ordinary loss on this transaction of $450 because of worthlessness. This is our contention. Let me ask one more question.

The Member: Because there was no sale or exchange?

Mr. Phillips: Because there was no exchange and no liquidation remaining.

Redirect Examination

By Mr. Phillips:

Q. Did you charge off on your books, Mr. Smith, all interests in the San Juan Mining Syndicate?

A. Yes.

The Member: The Petitioner now claims $1,000 as an ordinary loss?

Mr. Phillips: $1,000 as an ordinary loss by reason of worthlessness.

The Member: How did the taxpayer compute $666 in his return?

Mr. Phillips: I don't know why he did, and I don't know why the Commissioner asked 50%. I think you miscomputed your time of holding there between 1937 and 1939. [123]

(Testimony of John H. Smith.)

The Witness: I presume so. I don't know anything about the time on it now.

The Member: Well, the Commissioner rules there had been a loss on 50% instead.

Mr. Phillips: And we now take the position that he was entitled to the full 100% as of an ordinary loss.

The Member: I don't know but what that seems to be correct.

Mr. Tonjes: I don't think it is, your Honor.

The Member: There is no sale or exchange, the capital provision applies only to sale or exchange of capital assets. I think that is correct. Do you have anything further, Mr. Tonjes?

Mr. Tonjes: Offhand I can't say. I have gone into the law point, your Honor, but now offhand I can't say anything further at the moment, I guess.

The Member: All right.

Mr. Phillips: The Petitioner rests.

Mr. Tonjes: Respondent rests.

The Member: All right. I think we will have simultaneous briefs. I think that will be all right in the,—the first briefs will be due November 2 and reply briefs will be due November 17.

Mr. Tonjes: May I have leave of filing a reply, rather than an opening brief. I would rather, if it would [124] suit your convenience.

The Member: No, I want you to brief the case, Mr. Tonjes.

Mr. Tonjes: Very well.

(Whereupon, at 10:40 p. m., the hearing was concluded.)

[Endorsed]: U.S.B.T.A. Filed Oct. 14, 1942.

[125]

In the United States Circuit Court of Appeals for the Ninth Circuit

Tax Court
No. 110050

JOHN H. SMITH,

Petitioner on Review,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent on Review.

PETITION FOR REVIEW

To the Hon. Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

John H. Smith, Petitioner in the above cause, does hereby petition the United States Circuit Court of Appeals for the Ninth Circuit to review the decision of the tax court of the United States entered on April 7, 1943, ordering and deciding that there are deficiencies in income tax due from the taxpayer, John H. Smith, the Petitioner on Review, for the calendar years 1938 and 1939 in the respective amounts of $33,502.64 and $29,446.16. Taxpayer John H. Smith filed his Federal income tax returns for the calendar years 1938 and 1939

with the Collector of Internal Revenue for the District of Oregon, whose office is located at Portland, Oregon, and within the Judicial Circuit of the United States Circuit Court of [148] Appeals for the Ninth Circuit. The taxpayer, John H. Smith files this petition pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

Nature of Controversy

Prior to December 10, 1934, the Petitioner, John H. Smith, rendered certain services in connection with the reorganization of Hawley Pulp and Paper Company. On December 10, 1934, in consideration of the services rendered prior thereto, Western Cooperage Company gave to the Petitioner an option to purchase, on or before January 1, 1940, at a purchase price of ten cents per share, the right to receive all of the Common Stock of Hawley Pulp and Paper Company in excess of 100,001 shares to be received by the said Western Cooperage Company. The purchase price of said stock as fixed in said option was not less than the market value of the said stock or the voting trust certificates representing said stock on December 10, 1934. This option was subsequently ratified and approved by the Board of Directors of Western Cooperage Company. Thereafter, in March of 1938, the Petitioner, John H. Smith, exercised his right under said option and purchased from Western Cooperage Company voting trust certificates representing 74,377 shares of Common Stock of Hawley Pulp and Paper Company. The said purchase

was [149] made pursuant to and in accordance with the terms of said option agreement. That the purchase price was 10 cents per share, or a total purchase price of $7,437.70. The said purchase price was paid by Petitioner to Western Cooperage Company during the calendar year 1938. During the calendar year 1938, in accordance with instructions given by Western Cooperage Company to the depository holding said voting trust certificates, there was delivered to the Petitioner, John H. Smith, under the terms of said option, voting trust certificates representing 33,759 shares of Common Stock of Hawley Pulp and Paper Company.

That during the calendar year 1939, in accordance with instructions given by Western Cooperage Company to the depository holding said voting trust certificates, there was delivered to Petitioner John H. Smith, under the terms of said option, voting trust certificates representing 12,374 shares of the Common Stock of Hawley Pulp and Paper Company.

The Petitioner received the option to purchase the right to receive said stock or voting trust certificates representing said stock on December 10, 1934. At that time the option had no more than a nominal value and no return thereof was made in the income tax return [150] of John H. Smith for the calendar year 1934. No additional income was reported by the Petitioner, John H. Smith in the calendar years 1938 and 1939 by reason of the purchase of said stock under said option.

The Commissioner of Internal Revenue assessed

deficiencies in income tax for the year 1938 in the amount of $33,502.64, and asserted deficiency in income tax for the year 1939 in the amount of $29,444.39, which the Commissioner claimed to be a tax upon the difference in the amount paid for the voting trust certificates by the Petitioner, John H. Smith, and the alleged amount of their fair value at the time of the delivery of said voting trust certificates to the Petitioner, John H. Smith.

The Petitioner, John H. Smith, in his income tax return for the year 1939, claimed a loss on account of worthlessness of four units of interest in San Juan Mining Syndicate, which Petitioner John H. Smith had purchased on July 17, 1937 for the sum of $1000.00. The Petitioner in his return claimed a loss of $666.66 on account thereof. The Commissioner of Internal Revenue claimed that as a capital loss the amount thereof could not exceed $500.00. Before the United States Tax Court the Petitioner claimed a full loss of $1000.00 by reason [151] of worthlessness of his investment in the Syndicate.

The United States Tax Court held that the Petitioner, John H. Smith, had received income representing the difference between the option price of the voting trust certificates and the fair market value thereof during the calendar years 1938 and 1939, and that the loss on the units of San Juan Mining Syndicate was a capital loss and limited to $500.00. Accordingly, the Tax Court of the United States decided that there were deficiencies in income tax liability of John H. Smith, Petitioner.

for the years 1938 and 1939 in the respective amounts of $33,502.64 and $29,446.16.

/s/ JOHN H. SMITH,
/s/ CLARENCE D. PHILLIPS,
Attorney for Petitioner on Review.
GRIFFITH, PECK, PHILLIPS & NELSON,
Counsel.

[Endorsed]: T. C. U. S. Filed May 19, 1943.

[152]

[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING PETITION FOR REVIEW

To J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, Washington, D. C.

You are hereby notified that John H. Smith, the Petitioner above named, did, on the 19th day of May, 1943, file with the Clerk of the Tax Court of the United States, at Washington, D. C., a Petition for Review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Tax Court heretofore rendered in the cause of John H. Smith, Petitioner, vs. Commissioner of Internal Revenue, Docket No. 110650. A copy of the Petition for Review as filed is hereto attached and served upon you.

Dated this 24th day of May, 1943.

CLARENCE D. PHILLIPS,
Attorneys for John H. Smith,
Petitioner.
GRIFFITH, PECK, PHILLIPS
& NELSON,
Of Counsel. [153]

Service of the above and foregoing notice, together with a copy of the Petition for Review mentioned herein is hereby acknowledged this 29th day of May, 1943.

(S) J. P. WENCHEL,
Chief Counsel.

By .....
Counsel for Respondent on
Review.

[Endorsed]: T.C.U.S. Filed June 9, 1943. [154]

[Title of Circuit Court of Appeals and Cause.]

STATEMENT OF POINTS TO BE RELIED UPON

Comes now the Petitioner on Review herein, and makes this concise statement of points on which he intends to rely on the review herein, to-wit:

The United States Tax Court erred as follows:

1. In holding and deciding that the Petitioner, John H. Smith, received additional income during the calendar year 1938.

2. In holding and deciding that the Petitioner,

John H. Smith, received additional income for the calendar year 1939.

3. In holding and deciding that the Petitioner, John H. Smith, sustained a capital loss and allowed only 50 per cent. thereof by reason of his loss of investment in San Juan Mining Syndicate. [155]

4. In holding and deciding that the Petitioner, John H. Smith, received compensation to the extent of the difference between the option price for the purchase of voting trust certificates representing Common Stock of Hawley Pulp and Paper Company, and the market value thereof during the respective years 1938 and 1939.

5. In holding and deciding that the Petitioner, John H. Smith, realized gains in the taxable years 1938 and 1939 pursuant to the exercise of his option to purchase the right to receive voting trust certificates representing Common Stock of Hawley Pulp and Paper Company.

6. In failing to hold and decide that the option which Petitioner, John H. Smith, received on December 10, 1934, was for services rendered prior to December 10, 1934, and that if any income was received by John H. Smith, Petitioner, it was the value of the option on December 10, 1934 and that such compensation was received in the calendar year 1934.

7. In failing to hold and decide that after December 10, 1934 the Petitioner, John H. Smith, was a party to a bona fide option agreement for the sale and purchase of voting trust certificates representing said Common Stock, and that any

gains upon said transaction would be reported upon the sale thereof by the Petitioner, [156] John H. Smith with a basis to determine gain or loss in the amount of 10 cents per share.

8. In deciding and ordering that there are deficiencies and income tax liabilities for the years 1938 and 1939 in the respective amounts of $33,502.64 and $29,446.16.

9. In failing to decide and order that there was no deficiency in income tax due by the taxpayer, John H. Smith for the calendar years 1938 and 1939, respectively.

CLARENCE D. PHILLIPS,
Attorney for John H. Smith,
Petitioner.

Service of a copy of the within statement of Points to be Relied Upon is hereby admitted this 29th day of May, 1943.

(S) J. P. WENCHEL,
Chief Counsel.

By .....
Attorney for Commissioner of
Internal Revenue.

[Endorsed]: T.C.U.S. Filed June 9, 1943. [157]

[Title of Circuit Court of Appeals and Cause.]

DESIGNATION OF PORTIONS OF RECORD, PROCEEDINGS AND EVIDENCE TO BE CONTAINED IN RECORD ON REVIEW

To the Clerk of the Tax Court of the United States:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals, for the Ninth Circuit, copies duly certified as correct of the following documents and records in the above entitled cause in connection with the Petition for Review by the Circuit Court of Appeals, for the Ninth Circuit, heretofore filed by John H. Smith, Petitioner on Review:

1. Docket entries.
2. Pleadings before the Board:

(a) Petition and copy of notice of deficiency and statement attached.

(b) Answer.

3. Opinion.
4. Board decision entered April 7, 1943.
5. The following exhibits, or portions thereof:

[158]

(a) Copy of report of Reorganization Committee of Hawley Pulp and Paper Company found on pages 1, 2, 3, 4 and 5 of Exhibit 1.

(b) Full copy of Exhibit 2.

(c) Full copy of Exhibit 3.

(d) Full copy of Exhibit 4.

(e) Full copy of Exhibit 5.

(f) Copy of page 13 of Exhibit 6 showing mar-

ket values of Hawley Pulp and Paper Company Common Stock.

(g) Full copy of Exhibit 7.

(h) Copy of Schedule E from income tax return of Western Cooperage Company for 1938, Exhibit (8) A.

6. Transcript of Testimony.

7. Petition for Review, together with proof of service of notice of filing Petition for Review and of service of a copy of Petition for Review.

8. Statement of points to be relied upon.

9. Orders of court enlarging time, if any.

10. This designation.

Said transcript to be prepared, certified and transmitted as required by law and the rules of the United States Circuit Court of Appeals for the Ninth Circuit.

CLARENCE D. PHILLIPS,
Attorney for John H. Smith,
Petitioner. [159]

Service of a copy of the within designation of portions of the record, etc., is hereby admitted and agreed to this 29th day of May, 1943.

(S) J. P. WENCHEL,
Chief Counsel.

By .....
Attorney for Commissioner
of Internal Revenue.

[Endorsed]: T.C.U.S. Filed June 9, 1943. [160]

The Tax Court of the United States
Washington

Docket No. 110050.

JOHN H. SMITH,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

CERTIFICATE

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 160, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 16th day of June, 1943.

[Seal] B. D. GAMBLE,
Clerk, The Tax Court of the
United States.

[Endorsed]: No. 10478. United States Circuit Court of Appeals for the Ninth Circuit. John H. Smith, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the Tax Court of the United States.

Filed June 28, 1943.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 10478

JOHN H. SMITH, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition to Review a Decision of the Tax Court of the United States

Proceedings had in the United States Circuit Court of Appeals for the Ninth Circuit

Excerpt from Proceedings of Friday, January 21, 1944.
Before WILBUR, DENMAN, and MATHEWS, Circuit Judges.

Order of submission

Ordered petition to review argued by Mr. Clarence D. Phillips, counsel for petitioner, and by Mr. James P. Garland, Special Assistant to the Attorney General, counsel for respondent, and submitted to the court for consideration and decision.

Excerpt from Proceedings Thursday, May 25, 1944.
Before WILBUR, DENMAN, and MATHEWS, Circuit Judges.

Order directing filing of opinion and filing and recording of judgment

By direction of the Court, ordered that the typewritten opinion this day rendered by this Court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this Court in accordance with the opinion rendered.

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 10478—May 25, 1944

JOHN H. SMITH, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition to Review a Decision of the Tax Court of the United States

Before WILBUR, DENMAN, and MATHEWS, Circuit Judges.

MATHEWS, Circuit Judge.

Here for review is a decision of the Tax Court of the United States which determined that there were deficiencies in respect of petitioner's

income taxes for 1938 and 1939. The Tax Court held (1) that, in his return for 1938, petitioner had understated his income by $81,021.60; (2) that, in his return for 1939, he had understated his income by $71,663.98; and (3) that, in computing his net income for 1939, he had deducted, on account of a loss sustained in that year, $166.66 more than he was entitled to deduct. These holdings are assigned as error.

First. Petitioner, a resident of Oregon, was an employee of Western Cooperage Company, an Oregon corporation, hereafter called Western. Western managed Hawley Pulp & Paper Company, a Delaware corporation, hereafter called Hawley, under a contract which provided that, as compensation for managing Hawley, Western should receive 174,378 shares of common stock in Hawley. On December 10, 1934, as compensation for services theretofore rendered to Western by petitioner, Western granted petitioner an option to purchase from Western, on or before January 1, 1940, at a price of $7,437.70 (10 cents a share), 74,377 of the 174,378 shares of common stock which Western was to receive from Hawley. Petitioner exercised his option in 1938 by paying western $7,437.70.

Of the 74,377 shares of Hawley stock so purchased and paid for by petitioner in 1938, 23,759 shares were delivered to him in 1938. These shares, at the time of their delivery to petitioner, had a fair market value of $84,397.50. Thus, at the time of their delivery to petitioner, their fair market value exceeded their cost by $81,021.60. The Tax Court held that the excess ($81,021.60) was compensation for petitioner's services, hence was income to him and should have been so reported in his 1938 income-tax return and, since it was not so reported, held that petitioner had understated his income by $81,021.60.

We think that, in so holding, the Tax Court erred. Petitioner's Hawley stock was not issued to him as compensation for services, but was purchased by him pursuant to an option.[2] The option was granted him as compensation for services, but the option was not stock or the equivalent of stock. In order to acquire the stock, petitioner had to purchase it, and did purchase it. There was no finding, nor any basis for finding, that the option was intended to enable petitioner to make a "bargain purchase."[3] Instead, the Tax Court found that, at the date of the option, the market value of the stock did not exceed the option price of 10 cents a share. That the parties acted in good faith was not questioned. There was, therefore, no basis for holding that the difference between the option price of the stock and its mar-

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[1] As in Old Colony Trust Co. v. Commissioner, 1 Cir., 59 F. 2d 168; Crowell v. Commissioner, 6 Cir., 62 F. 2d 51; Olsen v. Commissioner, 7 Cir., 67 F. 2d 726; Mason v. Commissioner, 6 Cir., 125 F. 2d 540.

[2] As in Rothwell v. Commissioner, 10 Cir., 77 F. 2d 50, Rossheim v. Commissioner, 3 Cir., 92 F. 2d 247; Hawke v. Commissioner, 9 Cir., 109 F. 2d 946. See, also, Gardner Denver Co. v. Commissioner, 7 Cir., 75 F. 2d 38; Omaha National Bank v. Commissioner, 8 Cir., 75 F. 2d 434.

[3] As in Connolly's Estate v. Commissioner, 6 Cir., 135 F. 2d 64.

ket value when delivered to petitioner was compensation for his services,[4] or was income to him, or that his income was understated.

Holding, as we do, that the difference between the option price of the stock and its market value when delivered to petitioner was not income, we need not consider Article 22 (a)-1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938;[5] for that which is not income cannot be made income by Treasury Regulations.[6]

If upon their delivery to him in 1938, petitioner had sold the 33,759 shares of Hawley stock at their then market value, he would have realized gain therefrom, and that gain would have constituted income; but there was no such sale. Petitioner did not sell or dispose of any of his Hawley stock until 1940.

Second. Of the 74,377 shares of Hawley stock purchased and paid for by petitioner in 1938, 12,374 shares were delivered to him in 1939. These shares, at the time of their delivery to petitioner, had a fair market value of $72,901.38. Thus, at the time of their delivery to petitoner, their fair market value exceeded their cost by $71,663.98. The Tax Court held that the excess ($71,663.98) was compensation for petitioner's services, hence was income to him and should have been so reported in his 1939 income tax return and, since it was not so reported, held that petitioner had understated his income by $71,663.98.

We think that, in so holding, the Tax Court erred. The reasons for this conclusion have been stated already and need not be repeated.

Third. On July 17, 1937, petitioner purchased four units of interest in San Juan Mining Syndicate, hereafter called San Juan, for $1,000. The units became worthless on or about April 25, 1939, and were charged off by petitioner. In computing his net income for 1939, petitioner deducted, on account of the loss resulting from the units becoming worthless, $666.66 (two-thirds of $1,000). He contended before the Tax Court, and contends here, that the loss was an ordinary loss incurred in a transaction entered into for profit, and that therefore he was entitled to deduct the full amount thereof ($1,000). The Tax Court held that San Juan was a corporation; that units of interest in San Juan were shares of stock in a corporation and hence were securities; that the loss resulting from the units becoming worthless should be considered as a loss from a sale or exchange of capital assets on the last day of 1939; and that therefore petitioner was entitled to deduct only 50% ($500) of the loss.[7]

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[4] See cases cited in footnote 2.

[5] Article 22(a)-1 provides: "If property is transferred to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be."

[6] Commissioner v. Van Vorst, 9 Cir., 59 F. 2d 677; Hawke v. Commissioner, supra.

[7] Revenue Act of 1938, § 23 (e).

[8] Revenue Act of 1938, §§ 23 (g), 117 (a), 117 (b), 901 (a).

Petitioner contends that San Juan was not a corporation, but was merely a syndicate, and that therefore the Tax Court's holding was wrong. As used in the Revenue Act of 1938, the term "corporation" includes "associations, joint-stock companies, and insurance companies." [9] A syndicate may be an association and hence a corporation, within the meaning of the Act.[10] Respondent, the Commissioner of Internal Revenue, determined that San Juan was a corporation. No evidence to the contrary was offered by petitioner. Accordingly, and properly, the Tax Court accepted respondent's determination and held that petitioner was entitled to deduct only $500 of the loss resulting from the units becoming worthless. In this we find no error.

Decision reversed and case remanded for further proceedings in conformity with this opinion.

(Endorsed:) Opinion. Filed May 25, 1944. Paul P. O'Brien, Clerk.

Judgment

Upon Petition to Review a Decision of the Tax Court of the United States.

This cause came on to be heard on the Transcript of the Record from the Tax Court of the United States and was duly submitted:

On consideration whereof, it is now here ordered and adjudged by this Court, that the decision of the said Tax Court in this cause be, and hereby is reversed, and that this cause be, and hereby is remanded to the said Tax Court for further proceedings in conformity with the opinion of this court.

(Endorsed:) Judgment. Filed and entered May 25, 1944. Paul P. O'Brien, Clerk.

I, Paul P. O'Brien, as Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing one hundred and seventy-nine (179) pages, numbered from and including 1 to and including 179, to be a full, true, and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of Hon. Charles Fahy, Solicitor General of the United States, counsel for the respondent, and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 1st day of August 1944.

[SEAL] PAUL P. O'BRIEN, *Clerk.*

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[9] Revenue Act of 1938, § 901 (a) (2).
[10] Helm & Smith Syndicate v. Commissioner, 9 Cir., 136 F. 2d 449.

U. S. GOVERNMENT PRINTING OFFICE: 1944

Supreme Court of the United States

Order allowing certiorari

Filed October 16, 1944

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

U. S. GOVERNMENT PRINTING OFFICE: 1945

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FILED
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CHARLES ELMORE CROPLEY
CLERK

No. 371

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN H. SMITH

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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604603—44

In the Supreme Court of the United States

OCTOBER TERM, 1944

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN H. SMITH

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in this case.

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 21–37) is not officially reported. The opinion of the Circuit Court of Appeals is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 25, 1944 (R. 176). The jur-

isdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, upon the receipt of stock purchased under an option granted to the respondent in an earlier year as compensation for personal services, the respondent realized taxable income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code, in the amount of the excess of the fair market value of the stock at the time of acquisition over the option price.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Section 22 (a) of the Internal Revenue Code (26 U. S. C., Sec. 22), applicable to 1939, is identical.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

> ART. 22 (a)–1. *What included in gross income.*—
>
> * * * * *
>
> If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock, as to which see article 22 (a)–8.
>
> * * * * *

Section 19.22 (a)–1 of Treasury Regulations 103, promulgated under the Internal Revenue Code, is identical.

STATEMENT

The following are the relevant facts as found by the Tax Court (R. 22–30):

The respondent, an individual, had for many years been employed by the Western Cooperage Company ("Western"); and at the time of the hearing before the Tax Court was its general manager (R. 22). At the request of a bondholder's committee of the Hawley Pulp and Paper Company ("Hawley"), which had been in financial difficulties before 1933, Western took over the management of that corporation (R. 22–23). The respondent was personally active in the reorganization of Hawley, which took place in 1934 (R. 23). He interviewed many of the holders of Hawley securities and obtained the deposit of a substantial amount of securities under the reorganization plan (R. 23). Under the plan adopted, Western was to continue, at its option, to manage Hawley so long as it was not in default under the plan, which provided that the management, under Western, was to retire certain amounts of indebtedness each year (R. 23).

Western was to be compensated for management services by receiving from a depositary of

Hawley stock, after the retirement of $1,400,000 of Hawley's total indebtedness of $2,790,150, a proportion of the total number of shares deposited equal to the proportion of the total indebtedness retired (R 23–24).

To reward respondent for the services which he had rendered in connection with the reorganization, Western's president and general manager granted him an oral option in December 1934 (R. 24). On the advice of counsel, Western in May 1937 adopted a corporate resolution authorizing the execution of a formal written option embodying the terms of the oral option (R. 24). The resolution stated that the option was granted to the respondent (R. 24)—

> in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company and in bringing about the deposit of securities enabling the confirmation of said plan * * *.

The written option executed pursuant to the resolution was dated as of December 10, 1934, and contained a similar recitation of the consideration for which it was given (R. 25). It conferred upon respondent the right to purchase, on or before January 1, 1940, Western's rights in a portion of the shares on deposit (R. 25) at a price which was found by the Tax Court to have been not less than the market value of the shares

at the time when the oral option was granted (R. 27–28). The option provided that if by reason of management defaults Western should be entitled to receive only a portion of the deposited Hawley stock, Western would upon exercise of the option file with the depositary a written notice that it had sold its right to receive the stock subject to the option and would order the depositary to deliver to the respondent a portion of the stock which it would be entitled to receive, in approximately the ratio which the stock subject to the option bore to the entire amount of stock on deposit (R. 26–27).

On or before March 18, 1938, Western reduced the outstanding indebtedness of Hawley by $1,409,720 (R. 27). On that date the respondent exercised his option, paying Western $7,437.70 for its rights with respect to the stock here involved (R. 27); and Western directed the depositary to deliver stock to the respondent (R. 28). On the following day, March 19, 1938, the respondent received from the depositary Hawley stock having a fair market value of $81,021.60 more than the portion of the price paid under the option allocable thereto; and during 1939 he received Hawley stock as to which such excess was $71,663.98 (R. 28, 29).

The Commissioner determined that such amounts constituted taxable income to the respondent in the respective years. The Tax Court

sustained this determination on the ground that the amounts represented compensation received for personal services (R. 21–37). The court below reversed (R. 176).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court erred in holding that the respondent did not receive taxable income in the amount of the excess of the market value of the stock when received over the option price, and in reversing the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

We believe that the decision below conflicts with the decision of the Circuit Court of Appeals for the Sixth Circuit in *Connolly's Estate* v. *Commissioner*, 135 F. (2d) 64. In that case as here, the taxpayer received an option to purchase stock as compensation for services, and exercised the option in a later year when the market price had risen. It was held that the entire excess of the market price at the time of purchase over the option price constituted taxable income in the year of purchase.

The court below apparently sought to distinguish that decision on the ground that there the market price exceeded the option price both at the time of the granting of the option and at the time of its exercise (R. 174). This additional circumstance does not negative the existence of a conflict, however, since it was held in the

Connolly case that the taxpayer had received income not merely in the amount of the spread at the time the option was granted, but in the amount of the greater spread at the time it was exercised. The controlling circumstance was that the option was given as compensation for personal services. In this essential respect that case is identical with the present. The Tax Court expressly found (R. 24, 25), and the circuit court of appeals conceded (R. 174), that the option in the present case was granted for the very purpose of paying compensation for personal services. As the Tax Court observed, that fact was indisputable, for it was so stated in the corporate resolution and in the option itself, and the taxpayer testified to the same effect (R. 33). The option could not have been intended as compensation unless it was contemplated that the respondent would profit by a rise in the market value of the stock, which was continuously quoted on the local exchange (R. 102). The market value of the stock at the time the option was given was not in excess of the option price (R. 27–28); moreover, the option related only to the right of Western to receive Hawley stock (R. 25), which right was contingent upon the fulfillment by Western of the conditions embodied in the plan of reorganization (R. 26). Thus it is evident that here, as in the *Connolly* case, the taxpayer was meant to be compensated by a favorable exer-

cise of the option. That the cases are not distinguishable was the conclusion of the Tax Court (R. 32–23).

The decision by the court below was not required by any decision of this Court. In *Palmer* v. *Commissioner*, 302 U. S. 63, relied upon below by the respondent, the issue was whether there was a taxable dividend where a corporation issued to the stockholders options to purchase assets at a price which did not appear to be below the market price at the time of issuance. After issuance of the options the market price rose. The Board of Tax Appeals found that there was no intention to distribute any earnings of the corporation to its stockholders (302 U. S. at p. 67). This Court held that to establish that such a transaction amounts to a dividend (p. 70)—

> it is at least necessary to make some showing that the transaction is in purpose or effect used as an implement for the distribution of corporate earnings to stockholders.

Cf. *Choate* v. *Commissioner*, 129 F. 2d 684 (C. C. A. 2d); *Gibson* v. *Commissioner*, 133 F. 2d 308 (C. C. A. 2d), petition for a writ of certiorari dismissed, 320 U. S. 805. In the present case, on the other hand, the transaction in its purpose and effect constituted the award of compensation to the taxpayer.

The question presented is of importance in the administration of the law. The Bureau of Internal Revenue has informed us that devices like that here involved are being used with considerable and increasing frequency, in the apparent expectation of minimizing tax liability by payment of tax at capital gain rates on sale rather than at ordinary income rates,[1] and with the view also of circumventing restrictions imposed by the salary stabilization program;[2] and that serious administrative difficulties have resulted. We believe that a decision by the Court in this case would be in the public interest.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.

AUGUST 1944.

---

[1] The effect of such a device upon liability for income taxes comes into question in a variety of situations: Where, as in this case, the employee denies that the excess of market value over price paid constitutes ordinary income; where the employer seeks to deduct the amount of the excess as a business expense; and where the property purchased is subsequently sold, raising questions of basis and of the period for which the stock was held.

[2] See Sec. 1002.6 of T. D. 5295, 1943 Cum. Bull. 1193.

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No. 371

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN H. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

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JURISDICTION

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Section 19.22 (a)-1 of Treasury Regulations 103, promulgated under the Internal Revenue Code, is identical.

STATEMENT

The following facts were found by the Tax Court (R. 22–30):

The respondent had for many years been employed by the Western Cooperage Company (hereinafter called Western), and at the time of the hearing before the Tax Court was its general manager. (R. 22.) At the request of a bondholders' committee of the Hawley Pulp and Paper Company (hereinafter called Hawley), which had been in financial difficulties before 1933, Western took over the management of that corporation. (R. 22–23.) The respondent was personally active in the reorganization of Hawley, which took place in 1934. (R. 23.) He interviewed many of the holders of Hawley securities and obtained the deposit of a substantial amount of securities under the reorganization plan. (R. 23.) Under the plan adopted, Western was to continue, at its option, to manage Hawley so long as it was not in default under the plan, which provided that the management, under Western, was to retire certain amounts of indebtedness each year. (R. 23.)

Western was to be compensated for management services by receiving from a depositary of Hawley stock, after the retirement of $1,400,000 of Hawley's total indebtedness of $2,790,150, a

proportion of the total number of shares deposited equal to the proportion of the total indebtedness retired. (R. 23.) Thereafter the remaining shares were to be delivered to Western on the same basis. (R. 23–24.) Of the Hawley common stock 174,378 shares were deposited pursuant to the reorganization plan. (R. 24.)

To reward respondent for the services which he had rendered in connection with the reorganization, Western's president and general manager granted him an oral option in December 1934. (R. 24.) On the advice of counsel, Western in May 1937 adopted a corporate resolution authorizing the execution of a formal written option embodying the terms of the oral option. (R. 24.) The resolution stated that the option was granted to the respondent (R. 24)—

> in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company and in bringing about the deposit of securities enabling the confirmation of said plan * * *.

The written option executed pursuant to the resolution was dated as of December 10, 1934, and contained a similar recitation of the consideration for which it was given. (R. 24–25.) According to the terms of the option so granted, respondent was entitled to purchase, on or before January 1, 1940, at a price of $7,437.70, the right to receive

all Hawley common stock to which Western might become entitled in excess of 100,001 shares. (R. 25–26.) The option provided that if by reason of management defaults under the plan of reorganization Western should be entitled to receive only a portion of the deposited Hawley common stock, Western would, upon exercise of the option, file notice with the depositary that it had sold its right to receive 74,377 shares, and would order the depositary to deliver to respondent four shares for each six shares delivered to Western until all but 7,710 of the shares were delivered, and then to deliver this balance to the respondent. (R. 26–27.)

The price set in the option was not less than the market value of the price of the Hawley common stock at the time the oral option was granted. (R. 24, 27–28.)

On or before March 18, 1938, Western reduced the outstanding indebtedness of Hawley by $1,409,720. (R. 27.) Respondent exercised his option and made payment by check dated March 21, 1938. (R. 27.) By an order dated March 18, 1938, Western directed the depositary to deliver 50,939½ shares of Hawley common stock to itself, and 33,759 shares to respondent, which he received on the following day. (R. 28.) From time to time in 1939 respondent received additional shares of Hawley common stock in the total number of 12,374. (R. 28.)

Respondent did not report any income for the year 1934 on account of the receipt of the option. (R. 28.) The excess of the fair market value of the stock received over the option price was $81,-021.60 in the year 1938, and $71,663.98 in the year 1939. (R. 29.) The Commissioner determined that such amounts constituted taxable income to the respondent in the respective years. The Tax Court sustained this determination on the ground that the amounts represented compensation received for personal services. (R. 21–37.) The court below reversed. (R. 176.)

SPECIFICATION OF ERRORS TO BE URGED

The court below erred in holding that the respondent did not receive taxable income in the amount of the excess of the market value of the stock when received over the option price, and in reversing the decision of the Tax Court.

SUMMARY OF ARGUMENT

Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code includes within gross income, "gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid". The applicable Treasury Regulations require that where property is transferred by an employer to an employee for an amount substantially less than its fair market value, the employee shall include the difference in his gross income to

the extent that it is in the nature of compensation for services rendered, regardless of whether the transfer is in the form of a sale or exchange.

In the present case the Commissioner and the Tax Court determined that the excess of the market value of the Hawley stock when received over the option price was paid as compensation to the respondent, and accordingly included it in his gross income for the respective years of receipt. The Circuit Court of Appeals took a different view of the facts, and held that only the giving of the option was in the nature of compensation. The court erred in holding that there was no finding by the Tax Court, and no basis for a finding, that the option was intended to enable the respondent to make a bargain purchase. The Tax Court expressly found that the option was given as compensation for services, and that the option price was not less than the market value of the Hawley stock. Accordingly, the only method by which the option could serve as a device for remunerating the respondent would be through exercising it at a time when the value of the Hawley stock exceeded the option price. Thus, implicit in the Tax Court's decision is a finding that the option was intended to afford respondent an opportunity for a bargain purchase.

Further support for such a finding is found in the fact that Western would be unable to deliver

the Hawley stock upon the exercise of the option except under circumstances where the Hawley stock would be a bargain at the option price. Western would not receive the Hawley stock unless through its management the financial position of Hawley had improved, and such improvement would automatically bring about an increase in the value of the Hawley stock. Moreover, the Hawley stock, if acquired by Western as a result of its good management, would represent compensation to Western; and the option was but a means of sharing future earnings with respondent. The increase in value of the Hawley stock was not due to fortuitous circumstances beyond the control of the employer, and it is not true, as assumed by the court below, that the employer gave respondent a bare option.

ARGUMENT

UPON THE RECEIPT OF STOCK UNDER AN OPTION GRANTED TO HIM BY HIS EMPLOYER IN AN EARLIER YEAR AS COMPENSATION FOR PERSONAL SERVICES, THE RESPONDENT REALIZED TAXABLE INCOME WITHIN THE MEANING OF SECTION 22 (a) OF THE REVENUE ACT OF 1938 AND OF THE INTERNAL REVENUE CODE, IN THE AMOUNT OF THE EXCESS OF THE FAIR MARKET VALUE OF THE STOCK AT THE TIME OF RECEIPT OVER THE OPTION PRICE

This case turns on the application of Section 22 (a) of the Revenue Act of 1938 and of the

Internal Revenue Code, *supra,* which defines "gross income" as including—

> gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid * * *

The applicable Treasury Regulations (Article 22 (a)–1 of Treasury Regulations 101; Article 19.22 (a)–1 of Treasury Regulations 103), *supra,* provide:

> If property is transferred by * * * an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such * * * employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered * * *

The express words of the statute make the form of payment immaterial if, as a matter of fact, it is given as compensation for personal services. While the Regulations contain no further definition of compensation, there is a strong presumption that all gains flowing from the employer-employee relationship are in the nature of

compensation.[1] This may not always be true so far as bargain purchases are concerned. Conceivably such a bargain may occur where an employer can find no other buyer in a stagnant market, or even where the sole purpose is to ensure the employee's unflagging loyalty by giving him a stake in the employer's business.[2] If as a matter of fact, however, a transaction constitutes payment of compensation to the employee, its tax

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[1] See 54 Harv. L. Rev. 510, 511 (1941). From 1923 until the promulgation in 1939 of T. D. 4879, 1939–1 Cum. Bull. 159, the governing Treasury Regulations contained provisions substantially identical with the following provision of Article 22 (a)–1 of Treasury Regulations 94, promulgated under the Revenue Act of 1936:

"If property is transferred by * * * an employer to an employee, for an amount substantially less than its fair market value, such * * * employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value."

T. D. 3435, II–1 Cum. Bull. 50 (1923); Art. 31 of Treasury Regulations 65 and 69; Article 51 of Treasury Regulations 74 and 77; Article 22 (a)–1 of Treasury Regulations 86. This provision and the corresponding provision in Article 22 (a)–1 of Regulations 86 were amended by T. D. 4879, *supra*, to make them expressly state that such difference should be included "to the extent that such difference is in the nature of compensation for services rendered," as provided in the Regulations quoted in the text, and in subsequent Regulations (Sec. 29.22 (a)–1 of Treasury Regulations 111.) The effect of this amendment was to conform the Regulations to the course of judicial decisions. Cf. *White* v. *Winchester Club*, 315 U. S. 32.

[2] Cf., e. g., *Greeseman* v. *Commissioner*, 38 B. T. A. 258; *Adams* v. *Commissioner*, 39 B. T. A. 387.

consequences cannot be avoided by casting it in the form of a sale. *Connolly's Estate* v. *Commissioner*, 135 F. 2d 64 (C. C. A. 6th); *Erskine* v. *Commissioner*, 26 B. T. A. 147; *Epsen* v. *Commissioner*, 44 B. T. A. 322; cf. *Palmer* v. *Commissioner*, 302 U. S. 63, 69; *Phelps* v. *Commissioner*, 54 F. 2d 289 (C. C. A. 7th), certiorari denied, 285 U. S. 558; *Timberlake* v. *Commissioner*, 132 F. 2d 259 (C. C. A. 4th).[3] The amount received as compensation must be included in income of the year of receipt, and will be added to the basis of the property in computing gain or loss on subsequent sale, at least if it is actually returned by the taxpayer as gross income of the year of receipt. *Helvering* v. *Salvage*, 297 U. S. 106, affirming 76 F. 2d 112 (C. C. A. 2d); *Robinson* v. *Commissioner*, 59 F. 2d 1008 (C. C. A. 6th); Sec. 19.22 (a)-1 of Treasury Regulations 103; cf. *Larkin* v. *United States*, 78 F. 2d 951 (C. C. A. 8th); *Commissioner* v. *Farren*, 82 F. 2d 141 (C. C. A. 10th), certiorari granted, 298 U. S. 653, dismissed, 299 U. S. 617.

Where receipt of property from the employer is held not to constitute the payment of compensa-

[3] For the wide variety of plans for sale of an employer's assets to an employee, see Washington, Corporate Executives' Compensation (1942); Bastedo, Taxing Employees on Stock "Purchases," 41 Col. L. Rev. 239 (1941); Baker, Stock Options for Executives, 19 Harv. Bus. Rev. 106 (1940). Employers have not infrequently revised purchase plans to restore or increase their advantages to the employee. See, e. g., *Bothwell* v. *Commissioner*, 77 F. 2d 35 (C. C. A. 10th); *Evans* v. *Commissioner*, 38 B. T. A. 1406.

tion, the employee may be taxed only at the relatively lower capital gain rates on disposition of the property; and he may indeed escape all tax by postponing disposition to a year when, by reason of independent losses, his gain will not result in any taxable income. Section 117 of the Revenue Act of 1938 and of the Internal Revenue Code. The problem of determining whether particular dealings in property between employers and their employees give rise to taxable income has been a troublesome one for a quarter of a century, and has become very serious with the increases in taxation resulting from the war. While Congress has from time to time made special statutory provisions dealing with the tax aspects of transactions involving the receipt of compensation for personal services, the present case does not fall within any such provision.[4]

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[4] Section 165 of the Revenue Act of 1938 and of the Internal Revenue Code, which provides for special treatment of "employees' trusts", does not apply to the present case since no such trust is involved.

The first provision relating to employees' trusts found in the Revenue Acts is Section 219 (f) of the Revenue Act of 1921, c. 136, 42 Stat. 227, providing that a trust created by an employer as part of a stock bonus or profit-sharing plan for the exclusive benefit of his employees should not be taxable as a trust, but that "the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him". This was continued as Section 219 (f) of the Revenue Act of 1924, c. 234, 43 Stat. 253; and of the Revenue Act of 1926, c. 27, 44 Stat. 9. It was changed in

In determining whether a particular transaction involves the payment of compensation for personal services, the decisive factor is that of intention. *Bogardus* v. *Commissioner*, 302 U. S. 34; *Levey* v. *Helvering*, 68 F. 2d 401 (App. D. C.); *Mason* v.

Section 165 of the Revenue Act of 1928, c. 852, 45 Stat. 791, so that upon distribution to the beneficiary "there should be taxed to him as compensation the amount contributed by the employer toward the purchase of the stock, all cash dividends on the stock, any interest paid to the employee, and any other income received by him, but that any appreciation in the value of the stock over the cost to the trustee should not be taxed unless and until the gain is realized." H. Rep. No. 2, 70th Cong., 1st Sess., p. 22 (1939-1 Cum. Bull. (Part 2) 384, 398-399). As so altered this provision was reenacted as Section 165 of the Revenue Act of 1932, c. 209, 47 Stat. 169; of the Revenue Act of 1934, c. 277, 48 Stat. 680; and of the Revenue Act of 1936, c. 690, 49 Stat. 1648. Section 165 of the Revenue Act of 1938 limited its application to cases where it was impossible before satisfaction of all liabilities with respect to employees under the trust, for any part of the corpus to be used otherwise than for the exclusive benefit of the employees. The provision as so altered was carried into Section 165 of the Internal Revenue Code. Section 162 of the Revenue Act of 1942, c. 619, 56 Stat. 798, enacted in its stead a more restrictive and detailed statutory system. See S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 136-138.

Section 220 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862, added to the Internal Revenue Code, Section 107, which granted relief in cases where there was received in one year at least 95% of the payment for personal services extending over a period of five years or more. This does not apply to the present case for the reason, among others, that less than 95% of the compensation was received in 1939, the first year to which it applies.

Commissioner, 125 F. 2d 540 (C. C. A. 6th), certiorari denied, 317 U. S. 657; cf. *Palmer* v. *Commissioner, supra*, p. 70. This is, of course, a question of fact. Much of the inconsistency and confusion in the cases has resulted from the failure of appellate courts to accept decisions by the triers of fact on the issue of intention, even where supported by substantial evidence.[5] In some cases the appellate courts have found, upon their own appraisal of the evidence, that no part of the transaction was intended to confer compensation upon the employee; in others, of which the case at bar is typical, they have undertaken to split an integrated transaction into parts, and have held that only one part, such as the giving of a bare oral option, could have been intended as compensation. Whatever may have been the propriety of such broad appellate review under the decision in *Bogardus* v. *Commissioner, supra* (see *Hawke* v. *Commissioner*, 109 F. 2d 946, 950 (C. C. A. 9th), certiorari denied, 311 U. S. 657), it is no longer permissible since the overruling of the *Bogardus* decision *pro tanto* by *Dobson* v. *Commissioner*,

[5] See, e. g., *Omaha Nat. Bank* v. *Commissioner*, 75 F. 2d 434 (C. C. A. 8th); *Rossheim* v. *Commissioner*, 92 F. 2d 247 (C. C. A. 3rd); *Hawke* v. *Commissioner*, 109 F. 2d 946 (C. C. A. 9th), certiorari denied, 311 U. S. 657.

Appellate decisions have in turn had their influence on the Board of Tax Appeals and the Tax Court. See e. g., *Evans* v. *Commissioner*, 38 B. T. A. 1406, 1413. Cf. *Commissioner* v. *Heininger*, 320 U. S. 467.

320 U. S. 489, 494, rehearing denied, 321 U. S. 231. The *Dobson* case establishes beyond question that these are matters of fact not reviewable if based on substantial evidence. See also, *Elmhurst Cemetery Co.* v. *Commissioner*, 300 U. S. 37; *Palmer* v. *Commissioner*, 302 U. S. 63; *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282, rehearing denied, 305 U. S. 669; *Colorado Bank* v. *Commissioner*, 305 U. S. 23; *Helvering* v. *Lazarus & Co.*, 308 U. S. 252; *Wilmington Co.* v. *Helvering*, 316 U. S. 164; *Commissioner* v. *Heininger*, 320 U. S. 467; *McDonald* v. *Commissioner*, decided by this Court, November 20, 1944; *Commissioner* v. *Scottish American Inv. Co.*, decided by this Court, December 4, 1944.

The court below reversed the decision of the Tax Court on the ground that it had not found, and could not have found upon the evidence, that the option was intended to enable the respondent to make a bargain purchase. In the view of the facts taken by the court below, only the bare option could be regarded as having been given for the purpose of compensating the respondent; and, since that had no value, the respondent could not have received any compensation. (R. 174–175.) The Tax Court, on the other hand, regarded the giving of the option as but one part of an integrated transaction culminating in the payment of compensation to the respondent by deliveries of stock in 1938 and 1939. (R. 21–37.) The correctness of this view does not depend upon

imputation of bad faith or evasive motives;[6] it is simply a permissible construction of a transaction which might have been entered into solely for business purposes without regard to tax consequences.

We believe that the Tax Court in effect found that the option was intended to enable the respondent to make a bargain purchase, and that the evidence supported such finding. At the time of the reorganization, Hawley was in default on bond and note indebtedness totalling $2,790,150. (R. 23, 47, 52.) Western, respondent's employer, held about $27,000 of Hawley bonds. (R. 44.) Investigations of Hawley by committees representing its bondholders resulted in a committee recommendation that Hawley be reorganized under Section 77B of the Bankruptcy Act, and that Western assume the management of Hawley. (R. 46.) Western at first refused to undertake the management on the ground that its financial interest was insufficient to make it worth-while, but eventually did so in 1932 after reaching an understanding with other holders of Hawley securities as to compensation for its management services. (R. 46–48.) Under the plan adopted and

[6] While there were some indications in earlier days that bad faith must be found if a bargain purchase was to be held to have constituted the receipt of income (e. g., *Bradley* v. *Commissioner*, 1 B. T. A. 111, 118), it is now well settled that such a finding is unnecessary, and that the only inquiry is to the substance of the transaction. See cases cited in footnote 11, *infra*.

approved by the District Court in the reorganization case, not less than 85% of the common stock and second preferred stock of Hawley were to be deposited (R. 65), and the outstanding indebtedness was to be preserved without reduction in principal amount. (R. 56–58.) One of the seven directors was to be nominated by the committee for the second preferred and common stockholders in Hawley. (R. 55.) Western was given the right to discontinue its management of Hawley at its own option (R. 68), but was entitled to continue in management so long as it complied with numerous requirements laid down in the plan of reorganization. (R. 59–69.) As the sole compensation for its services (R. 124), Western was to receive, after retiring $1,400,000 of par value of Hawley's outstanding indebtedness, a proportion of the total number of shares deposited equal to the proportion of the total indebtedness retired; and upon retirement of additional amounts of indebtedness it was to receive annually additional amounts of the deposited stock in the same proportion. (R. 23, 65–66.) There were deposited, pursuant to the plan, 174,378 of the 200,000 outstanding shares of Hawley common stock. (R. 24, 127.)

In December of 1934, on the day of confirmation of the reorganization plan by the District Court, the president and general manager of Western gave the respondent an oral option to

purchase from Western its contingent rights in a portion of the deposited Hawley shares. (R. 24, 74, 77, 119). The purpose was to compensate the respondent for his services in connection with the reorganization (R. 24–25). In the respondent's own words (R. 74)—

> * * * he [the president and general manager of Western] made a promise to me, by saying that he wanted to reward my services * * * we made an option whereby he would reward me, made an agreement he would reward me for such services.

The oral option was ratified by formal corporate action in 1937, which expressed the same purpose. (R. 24–25.)

A witness for the respondent testified in the Tax Court that on the date when the respondent obtained the oral option Hawley's first mortgage bonds, secured by all its properties (R. 92), were selling at not to exceed $30 per hundred. (R. 119.) The only transfer of Hawley common stock known to the witness had been at 5 cents a share, and in his opinion the market price of the stock at the time was less than 10 cents a share. (R. 119.) The respondent himself testified that although the purpose of the option was to compensate him for his services (R. 74) the option "probably set a price that we felt was in excess of the market," and that if he could have sold the option at all

it would have been for a "negligible amount" (R. 107).

That the price set in the option on Western's contingent right to receive Hawley shares was no less than the market price of the shares themselves at the time the option was granted, and that the option itself was then substantially worthless, strongly indicate that the payment of compensation was intended to be the delivery of the stock, and not the conferring of the option itself. Cf. *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481, 499; *Connolly's Estate* v. *Commissioner, supra.* As the respondent himself testified, the option was a promise that he would be compensated; it was not in itself compensation. The gist of the option was that respondent would be paid only if Western should be paid; and that respondent would be given more than five years within which to decide whether to make Western's contingent promise binding by paying the option price. In this connection it is noteworthy that respondent did not report receipt of the option as income in 1934. (R. 28.)

Since the only way in which the option could serve to remunerate the respondent would be through exercising it at a time when the value of the Hawley stock exceeded the option price, the Tax Court's finding that there was a purpose to compensate the respondent is equivalent to a finding that there was an intention to afford him an opportunity for a bargain purchase. The case

is therefore specifically covered by the Treasury Regulations.

Further support for the finding that Western intended to enable the respondent to make a bargain purchase is furnished by the fact that Western would be unable to deliver the Hawley stock upon the exercise of the option except under circumstances where the Hawley stock would be a bargain at the option price. Western would not receive the Hawley stock unless through its management the financial position of Hawley had improved, and such improvement would automatically bring about an increase in the value of the Hawley stock. Moreover, the Hawley stock, if acquired by Western as a result of its good management, would represent compensation to Western; and the option was but a means of sharing future earnings with respondent. Thus the increase in value of the Hawley stock was not due to fortuitous circumstances beyond the control of the employer, and it is not true, as assumed by the court below, that the employer gave a bare option.

The Commissioner's determination must be sustained if the Tax Court made no "clear-cut mistake of law" in finding that the purpose and effect of the entire transaction was to pay the respondent compensation for his services by the delivery of the stock. *Dobson* v. *Commissioner*, *supra*, p. 502. From acceptance of the Tax Court's finding it will follow that the "normal rule" that income

is not realized by a bargain purchase must give way to the express words of Section 22 (a), requiring that there be included in gross income, compensation for personal services "in whatever form paid". It is of no moment that the services were rendered in a year prior to the year in which payment was received. *Lucas* v. *Ox Fibre Brush Co.*, 281 U. S. 115. The governing Treasury Regulations providing that where property is transferred by an employer to an employee for an amount substantially less than its fair market value, the employee shall include the difference in his gross income to the extent that it is in the nature of compensation for services, express well settled principles, are of long standing,[7] and must be deemed to have Congressional approval.[8]

The Circuit Court of Appeals erred in regarding the giving of the oral option in 1934 as the only time when income might possibly have been received;[9] for, as the Commissioner and the Tax Court have determined, the respondent received income only when, after exercising the option, he received the Hawley stock in 1938 and 1939. Where an option is a means for paying compensation for personal services, income is not usually

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[7] See footnote 1, *supra*.

[8] *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; *Helvering* v. *Reynolds Co.*, 306 U. S. 110, 115, 117; *Helvering* v. *Winmill*, 305 U. S. 79, 83.

[9] We find it unnecessary to rely on the apparent invalidity of the oral option until ratification by formal corporate action in 1937. (R. 115.)

received before the option is exercised. The employer's promise to transfer property expressed in the option is usually no more intended to be compensation for the employee's services than is the employer's promise to pay money wages or salary. Cf. *Shuster* v. *Helvering*, 121 F. 2d 643 (C. C. A. 2d). Neither promise is regarded as being, in itself, compensation; and it is intended that the employee wait for his compensation until he has rendered further performance. Until then, and until the employer makes the agreed return performance, the option is but a contingent promise which, under settled general principles,[10] has no immediate tax consequences for the employee, whether he returns his income according to the cash or the

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[10] *Lucas* v. *North Texas Lumber Co.*, 281 U. S. 11. See also *Lucas* v. *American Code Co.*, 280 U. S. 445; *North American Oil* v. *Burnet*, 286 U. S. 417; *Brown* v. *Helvering*, 291 U. S. 193; *Dixie Pine Co.* v. *Commissioner*, 320 U. S. 516; *Security Mills Co.* v. *Commissioner*, 321 U. S. 281. In *Palmer* v. *Commissioner*, *supra*, it was stated (302 U. S. 71)—

"The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition. Cf. *Miles* v. *Safe Deposit & T. Co.*, 259 U. S. 247; *Helvering* v. *San Joaquin Co.*, 297 U. S. 496; * * *. They are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise."

accrual method of accounting.[11] This is not to say that compensation can never be received in the form of an option to buy property from the employer, as where the employee is given a valuable option which is intended to constitute in itself the compensation. In such circumstances it would not be possible to postpone the receipt of income to a later year by refraining from exercising it. The express words of Section 22 (a), and the regard for substance rather than form which has consistently characterized the decisions of this

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[11] *Connolly's Estate* v. *Commissioner*, *supra*; *Olson* v. *Commissioner*, 67 F. 2d 726 (C. C. A. 7th), certiorari denied, 292 U. S. 637; *Hawke* v. *Commissioner*, *supra*; *Mason* v. *Commissioner*, *supra*; *Haberman* v. *Commissioner*, 79 F. 2d 995 (C. C. A. 2d), affirming 31 B. T. A. 75; *Lister* v. *Commissioner*, 3 B. T. A. 475; *Erskine* v. *Commissioner*, *supra*; *Kingsbury* v. *Commissioner*, 31 B. T. A. 1126; *Estate of Hessian* v. *Commissioner*, decided April 29, 1943 (1943 P-H T. C. Memorandum Decisions, par. 43,203). See *Springford* v. *Commissioner*, 41 B. T. A. 1001, 1007. Cf. *Schaefer* v. *Bowers*, 50 F. 2d 689 (C. C. A. 2d), certiorari denied, 284 U. S. 668; *Omaha National Bank* v. *Commissioner*, 75 F. 2d 434 (C. C. A. 8th); Washington, Corporate Executives' Compensation (1942), pp. 88 *et seq.*

See also the following cases concerning the right of the employer to take a deduction for compensation paid: *Alger-Sullivan Lumber Co.* v. *Commissioner*, 57 F. 2d 3 (C. C. A. 5th); *Indianapolis Glove Co.* v. *United States*, 96 F. 2d 816 (C. C. A. 7th); *International F. Corp.* v. *Commissioner*, 135 F. 2d 310 (C. C. A. 2d), affirming 45 B. T. A. 716; *Helvering* v. *Commercial Investment Trust Corp.*, 74 F. 2d 1015 (C. C. A. 2d), affirming 28 B. T. A. 143; *Hudson Motor Car Co.* v. *United States*, 3 F. Supp. 834 (C. Cls.); *Commissioner* v. *Texas Pipe Line Co.*, 87 F. 2d 662 (C. C. A. 3rd).

Court,[12] would require that in such a case the value of the option be included in gross income of the employee for the year of receipt. Cf., e. g., *Andrews* v. *Commissioner*, 135 F. 2d 314 (C. C. A. 2d) certiorari denied, 320 U. S. 748. See further, *Helvering* v. *San Joaquin Co.*, 297 U. S. 496, 498, rehearing denied, 297 U. S. 728. While we do not contend for a rule that would invite such wholesale attempts at tax avoidance as would an inflexible rule that taxable compensation cannot possibly be given in the form of an option, it must be recognized that in most cases, as in the present, the giving of the option is but an initial step in an inchoate transaction which will not culminate in the payment of compensation until a later time. In any particular case the question is one of fact as to which the determination of the Tax Court should be accepted as final if supported by substantial evidence.

The excess of the value of the property received over the option price normally constitutes income to the employee on exercise of the option, since the property is then actually delivered or unconditionally subjected to his control.[13] The present case is exceptional, however, in that the option

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[12] See, e. g., *Old Colony Tr. Co.* v. *Commissioner*, 279 U. S. 716; *Lucas* v. *Earl*, 281 U. S. 111; *Gregory* v. *Helvering*, 293 U. S. 465; *Douglas* v. *Willcuts*, 296 U. S. 1; *Higgins* v. *Smith*, 308 U. S. 473; *Helvering* v. *Clifford*, 309 U. S. 331; *Helvering* v. *Bruun*, 309 U. S. 461; *Helvering* v. *Horst*, 311 U. S. 112.

[13] See footnote 11, *supra*.

consisted only of a promise by Western to surrender to the respondent its *contingent* right to receive a portion of the Hawley shares. Western's right under the reorganization plan to receive the shares which were delivered to respondent in 1938 had become fixed and certain very shortly before the exercise of the option, and those shares were delivered by the depositary to the respondent almost immediately after he exercised the option. (R. 27–28, 106.) While the excess value of these shares was therefore properly included in respondent's gross income for the year 1938, the excess value of the shares received in 1939 could not have been included in his gross income of 1938. Western's right, and accordingly respondent's right, to receive the shares delivered to him in 1939 did not become fixed until "a day or two" before the respective times of delivery. (R. 27–28, 65–66, 106–107.) Even if the taxpayer had been on the accrual basis, the excess value of those shares would not have constituted income to him until the conditions upon his right to receive them had been fulfilled.[14]

[14] See footnotes 10 and 11, *supra*. Whether the respondent reported income according to the cash or accrual method of accounting does not appear from the record. Since the respondent had the burden of proof that the Commissioner's determination was erroneous (*Welch* v. *Helvering*, 290 U. S. 111, 115), it may not be assumed in respondent's favor that he employed the accrual method, if the method employed be thought a material factor. While we think that it clearly is not a material factor, it may be noted that on facts like those of the present case the excess of the value of the

The entire excess of the fair market value of the Hawley stock at the times of receipt over the option price was properly included in respondent's gross income of the respective years. As the Tax Court and the Commissioner have determined, the entire excess was paid as compensation for the respondent's personal services. That amount having been paid as compensation, it follows that it must be included in the respondent's gross income of the years of receipt. It is of no consequence in this connection that the form of payment was fulfillment of a promise contained in an option, or that the market price of the Hawley stock was no higher at the time the option was granted than the price set in the option. The statute makes the incidence of the tax turn upon the fact of payment of compensation without regard to intermediate promises, and plainly rejects the suggestion that its operation may be affected by the fortuitous circumstances of the presence or absence of a spread between the option price and the market price when the option was granted years earlier.

Palmer v. *Commissioner*, 302 U. S. 63, held that the sale of corporate assets to stockholders pursuant to rights which had been distributed to them was not a means for the distribution of

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stock received over the option price would very plainly have been includible as income to a taxpayer employing the cash method of accounting only upon receipt of the stock. *Avery* v. *Commissioner*, 292 U. S. 210.

dividends. The Court recognized, however, that in a case involving different facts the result might be different. In the *Palmer* case, however, the Board of Tax Appeals had found that the corporation which issued the rights had "no intention to distribute any of its earnings to stockholders and that the transaction was what it purported to be on its face—a sale to stockholders of part of the corporate assets." This Court accepted these findings, and stated the issue to be whether a transaction is taken out of the category of sales and placed in that of dividends solely because the stock which was the subject of the rights had increased in value after the rights were issued. (302 U. S. at 67, 70.) In the case at bar, however, the Tax Court found that the option was issued pursuant to an intention to compensate the taxpayer, and that the increase in value of the Hawley stock was not fortuitous but was due to the efforts of the corporation which issued the option.

Moreover, the *Palmer* case was an attempt to fit the distribution into the restrictive statutory definition of a dividend. In this case there is no similar restrictive provision. The statute involved in the *Palmer* case was Section 115 (a) of the Revenue Act of 1928, c. 852, 45 Stat. 791, which defined a dividend as a distribution by a corporation of its earnings and profits. This Court held that "it is at least necessary to make some showing that the transaction is in purpose or effect

used as an implement for the distribution of corporate earnings to stockholders." (302 U. S., p. 70). Here the taxing statute reaches compensation "of whatever kind and in whatever form paid," and the applicable Regulations specifically cover compensation paid in the form of a sale.

Accordingly, we submit that the *Palmer* case not only lends no support to respondent, but, on the contrary, its reasoning supports the Government's position here. The indispensable finding of intention which was lacking in the *Palmer* case is present here, and the breadth of the statute and Regulations applicable in this case is in contrast to the narrow definition involved in the *Palmer* case.

CONCLUSION

The decision below is erroneous and should be reversed.

Respectfully submitted.

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JANUARY 1945.

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No. 371

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN H. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM IN REPLY TO PETITION FOR REHEARING

In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 371

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

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JOHN H. SMITH

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM IN REPLY TO PETITION FOR REHEARING

1. The petition for rehearing and the brief *amici curiae* are devoted principally to an effort to establish that in its opinion this Court misstated the facts bearing upon the subsidiary question of the time when the income should be taxed. It is claimed that "the Tax Court found that the option was exercised in its entirety * * * in March, 1938 * * *" (A. C. 2);[1] that the taxpayer then "*purchased* said stock and acquired the right to have all of such stock delivered to

[1] In this memorandum "T." refers to the petition for rehearing; "A. C.," to the brief of *amici curiae*.

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him" (T. 5.); and that the "Tax Court stated in its opinion that the petitioner received compensation when he *exercised* his option and Western parted with the right to receive stock which had a much greater value than the option price" (A. C. 4).

The Tax Court actually stated, however (R. 33)—

> When petitioner *exercised his option and received the stock* [he] * * * received compensation to the extent of the differential. * * * The basic facts are that petitioner was given an option as compensation for services and that he realized gains in the taxable years pursuant to the exercise of this option. [Italics supplied.]

With respect to the decision of the Tax Court this Court stated in its opinion (p. 3) that—

> its finding that the option was given as compensation for respondent's services, had reference to the compensation to be derived from exercise of the option after the anticipated advance in market price of the stock. *The option could be exercised only when Western's contract with Hawley had been successfully performed* * * *. [Italics supplied.]

Western did not become entitled to the shares of stock successively delivered to the taxpayer in 1938 and following years until "a day or two"

before deliveries were actually made to him. (R. 106–107, 27–28, 65–66.) It is clear, therefore, that both this Court and the Tax Court regarded the fulfillment of the conditions upon the right of Western and the derivative right of the taxpayer (R. 23–24, 25–27), as essential to effective exercise of the option. References to exercise of the option elsewhere in the opinion of this Court presumably were made in the same sense as that quoted above.

The attack on the opinion of the Court ignores the special circumstances of the case, and assumes that the opinion deals with the conventional case where the right to receive the subject matter of the option is not contingent. Our brief on the merits (pp. 25–26) detailed the reasons why the special circumstances of this case required that the income be spread over the years of delivery. The taxpayer's brief made no answer to this portion of our argument, and the contention that the excess value of the shares should be included in his income for 1938 is made for the first time in his petition for rehearing (p. 5).[2] There is no occasion for further treatment of the matter at this juncture of the case, after it has been correctly and expressly decided by this Court and the Tax Court.

[2] The taxpayer's statement of points to be relied on in the court below (R. 167–168, par. 7), contended that if he had received any income, it was only in 1934 when he received the option.

2. There can be no question as to the value of the option at the time it was given. The taxpayer conceded in his brief in opposition (p. 5) that it had no value at that time, and has never asserted the contrary.

3. The relation of the present case to *Palmer* v. *Commissioner*, 302 U. S. 63, is in no need of "clarification." The assumption (A. C. 9, *et seq.*) that the cases involved identical problems is of course not warranted by the fact that both are dealt with in the same article of the Regulations. The cases arose in different fields and on different findings of fact. The question in the *Palmer* case was whether there had been a distribution of corporate earnings; in this case it was whether the taxpayer had received compensation. Here the taxpayer was required to pay tax upon compensation regardless of the form or source of the payment. In the *Palmer* case the Board found that the corporation had no intention to make any distribution by the issuance of the warrants, and this Court, after accepting that finding, held that there was no rule of law which required that it be held a dividend notwithstanding the corporate intention. This Court recognized that in a case involving different facts the result might be different. Here the Tax Court found that the very purpose and effect of giving the option was to compensate the taxpayer, and since the source of the payment is

immaterial here, the excerpt from the *Palmer* opinion relied on (A. C. 10–11) is wholly irrelevant.

CONCLUSION

The petition for rehearing should be denied.

Respectfully submitted,

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APRIL 1945.

U. S. GOVERNMENT PRINTING OFFICE: 1945

No. 371

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

JOHN H. SMITH, *Respondent*

RESPONDENT'S BRIEF OPPOSING PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 371

COMMISSIONER OF INTERNAL REVENUE, Petitioner

v.

JOHN H. SMITH, *Respondent*

RESPONDENT'S BRIEF OPPOSING PETITION FOR A WRIT OF CERTIORARI IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Commissioner of Internal Revenue, through the Solicitor General, has petitioned for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit. The Respondent opposes the granting of such a writ.

OPINIONS BELOW

The memorandum opinion of the Tax Court (R.21-37) is not officially reported but included in the Record. Opinica of the Circuit Court of Appeals is reported in 142 *Fed.* (2) 818.

The jurisdiction of the Court, the statutes and regulations involved, are stated in the petition for the writ of certiorari.

QUESTION PRESENTED

Whether, upon the receipt of stock purchased under an option which was granted to the Respondent in an earlier year as compensation for personal services performed prior to the date of the option, and where the option price was equal to or in excess of the then market value, the Respondent realized taxable income within the meaning of *Section 22*(a) *of the Revenue Act of* 1938 for any excess values accruing to the stock after the giving of the option.

STATEMENT

The Respondent calls this Court's attention to the following additional facts:

A reorganization of Hawley Pulp and Paper Company was had under the provisions of Section 77(b) of the Bankruptcy Act, under the terms of which Western Cooperage Company was to manage the Hawley Pulp and Paper Company (R. 46, 47). Under the provisions of the reorganization indenture Western Cooperage Company had the right to acquire, upon compliance with certain conditions, certain voting trust certificates representing the common stock

of Hawley Pulp and Paper Company (R. 50, 65, 66). At the time the option was given to John H. Smith on December 10, 1934, Western Cooperage Company did not own the stock of Hawley Pulp and Paper Company but only had the right to receive such stock under the terms of the reorganization indenture.

The option given to John H. Smith on December 10, 1934, was in consideration of services which had been *theretofore* rendered (R. 74, 83, 86). The purchase price was fixed at ten cents per share on the common stock, which was equal to or in excess of the market value at the time of the giving of the option (R. 90, 92, 101, 102, 118-121, 130).

The option agreement (R. 82-86) runs not only to John H. Smith, but to his heirs or assigns.

In the years 1940 and 1941 the Respondent John H. Smith sold part of the common stock which he had received and reported the profit thereon in his income tax returns for the respective years of 1940 and 1941, taking as a basis for the computation of profit the amount of ten cents per share which he had paid as the agreed price for said stock under said option (R. 93, 94, 95).

His future employment by Western Cooperage Company did not depend upon the option (R. 95).

ARGUMENT

The petition for writ of certiorari asserts that the decision below is in conflict wih the decision of the Circuit Court of Appeals for the Sixth Circuit in *Connolly's Estate* vs. *Commissioner*, 135 *Fed.* (2d) 64. The facts in the Connolly case are substantially different from those in the present case. The differences which appear in the Connolly case are as follows:

(a) At the time the options were granted the market value of the stock was nearly two and one-half times the option price;

(b) The employer in the Connolly case had voluntarily reduced the fixed salaries of certain employees, including Connolly, during a five-year period preceding the time of the granting of the options, and the designated employees, including Connolly, were then serving the corporation at a rate of fixed compensation greatly disproportionate to the value of their services;

(c) The option entitling the employees to purchase at a price less than the market value was given as adjusted compensation for services "heretofore rendered, and as an inducement to said Messrs. Hoagland and Connolly to continue in the employ of the corporation";

(d) The resolution revising the terms of the op-

tions recited that the revision was necessary if Hoagland and Connolly, through the medium of options, were to receive purchase rights which "in any real sense" would constitute compensation for valuable services theretofore and then being currently rendered by them to the corporation;

(e) The minutes of the corporation also recited that the services rendered had greatly exceeded in value any compensation received by them, and that the best interests of the corporation would be served by the "continued willingness of these persons to serve the corporation and to exercise in the administration of its affairs the same degree of time, effort and skill as heretofore, and as an inducement to that end," the Board of Directors granted the options "by way of adjusted compensation."

In other words, the parties in the Connolly case recognized that there was a value in excess of market value, and that such excess was in the nature of compensation for services being presently rendered and to be rendered in the future.

In the case below, Western Cooperage Company and John H. Smith arrived at an option price which was equal to or in excess of the then market value. There was no excess value at the time of the option. The option itself was the only thing given as compen-

sation for services which had been rendered prior to the time of the option. None of the parties intended that any excess values subsequently accruing should be compensation (R. 92). This intention is borne out by the fact that the Respondent John H. Smith has already paid his tax on the gains produced by the sale of part of this stock in 1940 and 1941, using as his basis the sum of ten cents per share, the agreed sale price under the option.

The option itself ran to Mr. Smith, his heirs or assigns. If he had died before exercising the option his heirs could have exercised the same and certainly the excess values would not be considered as compensation to such heirs. Mr. Smith could have sold the option and the excess value certainly would not have been considered compensation to his assigns.

This case below was determined in accordance with the weight of authority as expressed by the several Circuit Courts of Appeal in the following cases:

Bothwell v. *Commissioner*, 10 *Cir.*, 77 *F. 2d* 35; *Rossheim* v. *Commissioner*, 3 *Cir.* 92 *F. 2d* 247; *Hawke* v. *Commissioner*, 9 *Cir.* 109 *F. 2d* 946. See also *Gardner-Denver Co.* v. *Commissioner*, 7 *Cir.*, 75 *F. 2d* 38; *Omaha Nat. Bank* v. *Commissioner*, 8 *Cir.*, 75 *F. 2d* 434.

The legal question involved here is substantially

the same as that where stock of a corporation is sold to a stockholder. Such a question arises under the same section of the statute, and it is significant that *Treasury Regulations* 101, promulgated under the Revenue Act of 1938, *Article* 22(a)-1, contemplate both kinds of transactions under one regulation.

This Court has already ruled in the case of *Palmer* v. *Commissioner of Internal Revenue*, 302 *U. S.* 63, 82 *L. Ed.* 50, that such purchases by stockholders from a corporation, even though under options or rights, are not compensation where the option price is equal to or in excess of the then market value.

The Respondent respectfully submits that this cause gives no rise to an issuance of a writ of certiorari and that there is no conflict between the decision below and the decision of the Sixth Circuit Court of Appeals. This question has already been decided uniformly by the Circuit Court of Appeals in all cases that have comparable facts, and substantially the same question has been decided by this Court.

CONCLUSION

Respondent respectfully submits that the petition for writ of certiorari should be denied.

Respectfully submitted,

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No. 371

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

JOHN H. SMITH, *Respondent*

RESPONDENT'S BRIEF

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In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

JOHN H. SMITH, *Respondent*

RESPONDENT'S BRIEF

This case comes before this court upon the petition of the Commissioner of Internal Revenue for writ of certiorari which was granted by the above court on October 16, 1944, and the case transferred to the summary docket.

OPINIONS BELOW

Memorandum opinion of the Tax Court is not officially reported but included in the Record (R. 21-37). Opinion of the Circuit Court of Appeals for the Ninth Circuit is reported in 142 Fed. (2d) 818.

JURISDICTION

The petition for writ of certiorari was premised upon a purported conflict of decisions between the Ninth Circuit and the Sixth Circuit. The objection of the respondent to the assumption of jurisdiction in this case, and the reasons therefor, were given in re-

spondent's brief opposing the petition for writ of certiorari which has been filed in the Court and cause.

STATEMENT OF CASE

The Commissioner of Internal Revenue assessed deficiencies for the calendar years 1938 and 1939, asserting that the Taxpayer had received income in the amount representing the difference between the option price fixed in 1934 and the market values of the stock received by the Taxpayer in the years 1938 and 1939. The Tax Court of the United States held in favor of the Commissioner (R. 21-37). This decision was appealed to the Circuit Court of Appeals for the Ninth Circuit and that Court reversed the Tax Court on the issue concerning this common stock, the opinion being reported as *Smith v. Commissioner of Internal Revenue*, 142 *Fed.* (2*d*) 818.

The statute involved in this case is *Section* 22 (*a*) *of the Revenue Act of* 1938 shown in historical note. *Title* 26, *Section* 22, *page* 47, *U .S. C. A.*, which reads as follows:

> "Sec. 22 (a). General definition. 'Gross income' includes gains, profits and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the

transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing compensation of such Presidents and judges are hereby amended accordingly."

This section of the statute was amended sightly in 1939, but the effect of the amendment only involved employees of States or political subdivisions thereof.

Title 26, Sec. 22 (a) U. S. C. A.

The respondent, herein referred to as "Taxpayer," and so referred to in the Record, is a resident of Portland, Oregon, and filed his income tax returns for the years 1938 and 1939 at the Office of the Collector of Internal Revenue in Portland, Oregon. During the years 1934 to 1939 inclusive, the Taxpayer was an employee of Western Cooperage Company and at the time of the hearing in the Tax Court he was general manager of said Company (R. 41, 42, 43, 93).

Prior to 1933 Hawley Pulp & Paper Company, hereinafter referred to as Hawley Company, experienced financial difficulties and various committees representing the creditors, bondholders and stockholders were attempting to reorganize the company (R. 43) and the company was ultimately reorganized under the provisions of 77 B. of the Bankruptcy Act (R. 46).

Prior to the reorganization, a bondholders committee had been organized and the Western Cooperage Company was the owner of some of the bonds. At that time, and until the time of his death, Watson Eastman was president and general manager of Western Cooperage Company (R. 44, 45). Under the reorganization, as effected by the court proceedings under Section 77 B. of the Bankruptcy Act, the Western Cooperage Company was to manage the Hawley Company (R. 46, 47). Portions of the reorganization indenture applicable to this proceeding are included in Petitioner's Exhibit 1 (R. 50-71). The provisions of paragraphs "L" and "N" (R. 65, 68) are explained by one of the witnesses Cassius R. Peck (R. 123-127) showing that the Western Cooperage Company was to receive for its managerial services 174,378 shares of common stock of the Hawley Company upon the retirement of certain of the indebtedness (R. 85, 127). The common stock was represented by voting trust certificates. Pursuant to the plan of reorganization 174,378 shares of the Hawley Company's common stock was deposited with the depository, The Bank of California National Association. The voting trust certificates representing these shares were to be delivered to Western Cooperage Company under the reorganization agreement, upon performance of the agreement.

On December 10, 1934, Watson Eastman, president and general manager of Western Cooperage Company, gave to John H. Smith an oral option to purchase the right to receive all of the common stock of Hawley Pulp & Paper Company which the Western Cooperage Company would be entitled to receive in excess of 100,001 shares (R. 74-76, 115). The terms of this option were reaffirmed by the Board of Directors on May 4, 1937 (R. 77-82) and a written option agreement was entered into (R. 82-86) which embodied the terms of the oral agreement. This option granted to John H. Smith, his heirs or assigns, the right to purchase on or before January 1, 1940, the right to receive all of the common stock of Hawley Company in excess of 100,001 shares of common stock of the Hawley Company to be received by the Cooperage Company. The option price was fixed at $7,437.70, which was at the rate of ten cents per share for the 74,377 shares which would be available out of the stock acquired by Western Cooperage Company if and when they performed the agreement. The option price was equal to or in excess of the market value as of the date of the option on December 10, 1934 (R. 90-92, 101, 102, 118-121, 130).

On or about March 19, 1938, John H. Smith exercised his option to purchase and paid to the Western

Cooperage Company the sum of $7,437.70, which was included in a check shown as Exhibit 4 (R. 88, 89). In 1938, pursuant to the terms of the option agreement, the Taxpayer received voting trust certificates representing 33,759 shares of the Hawley common stock (R. 28). In 1939, pursuant to the same agreement, the Taxpayer received, at various dates, voting trust certificates representing additional common stock or a total number of 12,374 shares received in 1939 (R. 28), in accordance with demands made upon the depository (R. 94-101). Pursuant to such transactions the Western Cooperage Company made appropriate entry on its books showing the sale of the said common stock to the respondent for the sum of $7,437.70 (R. 141-153).

The option was not given for any service rendered in 1938 or 1939 or for services rendered in any year subsequent to 1934, but was only an honorarium for services which John H. Smith had performed in assisting the reorganization prior to December 10, 1934, all of which is recited in the resolutions of the Board of Directors and the option agreement itself (R. 76-86, 92, 95). The shares of stock were not given as the consideration for any services, but were transferred only pursuant to the option agreement. The option itself was the only consideration given for any services.

The Western Cooperage Company did not report

or attempt to take any deduction for any additional compensation paid to John H. Smith for the calendar years 1938 or 1939 (R. 93, 133, 134).

At the time the option was given on December 10, 1934, the market value of the common stock was less than ten cents per share (R. 90-92, 101, 102, 118-121, 130). In 1938 the common stock of Hawley Company had increased in market value and again increased in the year 1939 (R. 29, 109-113).

The future employment of John H. Smith by the Western Cooperage Company did not depend on the option (R. 95), and the option ran, not only to John H. Smith, but to his heirs or assigns (R. 82-86).

In the years 1940 and 1941 John H. Smith sold part of the common stock which he had purchased pursuant to the option agreement. He reported the profit thereon in his income tax returns for the respective years of 1940 and 1941, taking as a basis for the computation of profit the amount of ten cents per share which he had paid as the agreed price of said stock under the option agreement (R. 93, 94, 95).

ARGUMENT

The fundamental question in this case is whether or not the Taxpayer received taxable income in the years 1938 and 1939. In determining this question the Court must necessarily take into consideration the intentions of the parties as manifested by their words and actions with respect to the transaction in question. It must be remembered that the option was the only thing which was given to John H. Smith in 1934 and constituted the only compensation for any service that he rendered in connection with the attempted reorganization of the Hawley Company. Such services were all rendered prior to December 10, 1934. The option agreement itself was of negligible, if any, value. However, it could be sold by John H. Smith immediately, or, in case of his death, it would descend to his heirs or legatees. Under the circumstances it can hardly be said that it was the intention of the parties that the increase in value accruing to the stock between 1934 and 1938 should be considered as compensation to the Taxpayer when in case of a sale of the option by the Taxpayer, or in case of his death, such increase in value would accrue to a stranger to the transaction, who would not be an employee of Western Cooperage Co. It is also obvious from the arrangement made and particularly the provisions of the reorganization agree-

ment under which the Western Cooperage Company was to receive this stock, that no more than an option could be given. The Western Cooperage Company did not own the Hawley stock in 1934. They only had the right to receive stock if and when they performed under the reorganization agreement. In other words all that the Western Cooperage Company could agree to sell to John H. Smith in 1934 was their contingent right to receive the Hawley stock and delivery of the stock thereunder necessarily had to be postponed until such a time as the Western Cooperage Company was entitled to receive actual delivery of the voting trust certificates representing the stock.

This Court in defining the definition of income as referred to in the XVI Amendment and as provided for in Section 22 (a) of the Revenue Act has consistently followed the rule of including income only as it was actually received and not imposing a tax upon a fictious income.

In *Eisner v. Macomber*, 252 *U. S.* 189, 207, 40 *S. Ct.* 189, 64 *L. Ed.* 521, this Court defined income as follows:

> "Brief as it is, it indicates the characteristic and distinguishing attribute of income, essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief em-

> phasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived—*'derived-from-capital;'* —*'the gain-derived-from-capital,'* etc. Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being *'derived,'* that is, *received* or *drawn* by the recipient (the Taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the description.'
>
> "The same fundamental conception is clearly set forth in the 16th Amendment—'incomes, *from* whatever *source derived*,'—the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution."

The above definition followed in general that given by this court in *Doyle* v. *Mitchell Bros. Co.* 274 *U. S.* 179, 185, 38 *Sup Ct.* 467, 62 *L. Ed.* 1054.

These decisions were followed by that of *Merchants' Loan & Trust Co. v. Smietanka*, 225 *U. S.* 509, 519, 41 *Sup Ct.* 386, 65 *L. Ed.* 751, where the Court said:

> "In determining the definition of the word 'income' thus arrived at, this court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it is believed to be the commonly understood meaning of the term which

must have been in the minds of the people when they adopted the 16th Amendment to the Constitution. Doyle v. Mitchell Bros. 247 U. S. 179, 185, 62 L. Ed. 1054, 1059, 38 Sup. Ct. Rep. 467; Eisner v. Macomber 252 U. S. 189, 206, 207, 64 L. ed. 521, 528, 529, 9 A. L. R. 1570, 40 Sup. Ct. Rep. 189. Notwithstanding the full argument heard in this case and in the series of cases now under consideration, we continue entirely satisfied with that definition, and, since the fund here taxed was the amount realized from the sale of the stock in 1917, less the capital investment as determined by the trustee as of March 1, 1913, it is palpable that it was a 'gain or profit' 'produced by,' or 'derived from,' that investment, and that it 'proceeded,' and was 'severed' or rendered severable, from it, by the sale for cash, and thereby became that 'realized gain' which has been repeatedly declared to be taxable income within the meaning of the constitutional Amendment and the Acts of Congress. Doyle v. Mitchell Bros. Co. and Eisner v. Macomber, supra."

This court has also indicated that in gain or profit realized from personal property, the gain or profit resulting in taxable income is determined at the time of the sale of the personal property.

Goodrich v. Edwards, 255 *U. S.* 536, 41 *Sup. Ct.* 392, 65 *L. Ed.* 762.

Further definition of income was given by this court in *Bowers v. Kerbaugh-Empire Co.*, 271 *U. S.* 170, 46 *Sup. Ct.* 449, 70 *L. Ed.* 886. See, also, *Taft v. Bowers*, 278 *U. S.* 470, 481, 49 *Sup. Ct.* 199, 73 *L. Ed.* 460

This Court has also pointed out that with respect to gains or losses for income tax purposes that attention should only be given to realities and that gains and losses should only be reflected for purposes of income tax when they become realized gains or realized losses.

> *Weiss v. Weiner*, 279 *U. S.* 333, 49 *Sup Ct.* 337, 73 *L. Ed.* 720; *Lucas v. American Code Co.*, 280 *U. S.* 445, 50 *Sup. Ct.* 202, 74 *L. Ed.* 538; *Burnet v. Logan*, 283 *U. S.* 404, 51 *Sup. Ct.* 550, 75 *L. Ed.* 1143.

In *McLaughlin v. Alliance Insurance Co.*, 286 *U. S.* 244, 52 *Sup. Ct.* 538, 76 *L. Ed.* 1083, this Court summed up this principal as follows:

> "The tax under this and earlier revenue acts was imposed upon net income for stated accounting periods, here the calendar year 1928, see Burnet v. Sanford & B. Co., 282 U. S. 359, 363, 75 L. Ed. 383, 386, 51 S. Ct. 150, and it is only gain realized from the sale or other disposition of property, which is included in the taxable income. Realization of the gain is the event which calls into operation the taxing act, although part of the profit realized in one accounting period may have been due to increase of value in an earlier one. While increase in value of property, not realized as gain by its sale or other disposition, may, in an economic or bookkeeping sense, be deemed an addition to capital in a later period, see Merchants' Loan & T. Co. v. Smietanka, 255 U. S. 509, 65 L. Ed. 751, 15 A. L. R. 1305, 41 S. Ct. 386, it is nevertheless a gain from capital investment which, when realized, by conversion into money or other

property, constitutes profit which has consistently been regarded as income within the meaning of the Sixteenth Amendment and taxable as such in the period when realized. See Lynch v. Hornby, 247 U. S. 339, 62 L. Ed. 1149, 38 S. Ct. 543; Merchants' Loan & T. Co. v. Smietanka, 255 U. S. 509, 65 L. Ed. 751, 15 A. L. R. 1305, 41 S. Ct. 386, supra; Eldorado Coal & Min. Co. vs. Mager, 255 U. S. 522, 65 L. Ed. 757, 41 S. Ct. 390; Goodrich v. Edwards, 255 U. S. 527, 65 L. Ed. 758, 41 S. Ct. 390; Walsh v. Brewster, 255 U. S. 536, 65 L. Ed. 762, 41 S. Ct. 392; Taft v. Bowers, 278 U. S. 470, 73 L. Ed. 460, 64 A. L. R. 362, 49 S. Ct. 199; Lucas v. Alexander 279 U. S. 573, 73 L. Ed. 851, 61 A. L. R. 906, 49 S. Ct. 426; Willcuts v. Bunn, 282 U. S. 216, 75 L. Ed. 304, 71 A. L. R. 1260, 51 S. Ct. 125."

The Commissioner of Internal Revenue, in this case and in his application for writ of certiorari, sought jurisdiction upon the ground that there was a conflict of opinions between the several circuits. It is true that some of the Circuit Courts of Appeal have determined that income accrued to employees or stockholders of corporations in the event that they received stock or property from the corporation at less than the then market value. This court, however, will find, upon examining these cases, that they fall generally into three catagories. The first group of cases deals with transactions where the stock itself was either given or sold at a "bargain purchase" price and was frankly given with the intention by the parties that the difference between the purchase price and the market value should

be considered as compensation or additional compensation to the employee or stockholder. In another group of cases, the option agreement expressly provides that the increase in value between the purchase price and the market value was intended by the parties as compensation or additional compensation. The third group of cases deals with sales under options to an employee or stockholder without any manifest intent of the parties that the increase in value, if any, should be considered as compensation to the employee or stockholder. These several cases will be analyzed herein.

However, it must be remembered that the facts in this case show that the only compensation, although it was of doubtful and negligible value, was the option itself, given to the Taxpayer in 1934 for services rendered prior to December 10, 1934. It was not the intention of the parties that the increase in value, if any, should be considered as compensation to John H. Smith. In fact no one could know that there would be any increase in value. As shown by the record and the reorganization agreement the days of 1934 looked very dark for the Hawley Pulp & Paper Company. The intent of the parties was further evidenced by the terms of the option agreement itself and the reorganization indenture, which pointed out that the Western Cooperage Company could not possibly receive title to the Hawley stock until after it had performed its obliga-

tions under the reorganization indenture. This option ran to John H. Smith, and also to his heirs and assigns, which would permit him to sell the option if he so desired. In case of a sale of the option, after the granting thereof and prior to the delivery of any stock under said option, his assignee upon payment of the option price, would be entitled to demand delivery of the shares covered by the option. The increase in value received by such assignee could certainly not be considered as compensation for any services rendered by John H. Smith. In case of the death of John H. Smith prior to the delivery of any stock under said option, the executors, heirs or legatees of John H. Smith could, upon payment of the option price, compel delivery to them of such stock. The increase in value received by such executor, heir or legatee would not be considered as compensation for any services rendered by John H. Smith. He performed no services in 1938 or 1939 for which this might be considered as compensation. He was paid his regular salary during 1938 and 1939 for what services he did perform. He paid for the full block of stock in 1938 and there was nothing left for him to do after that time of exercising his option except to take delivery of the stock, if and when the Western Cooperage Company became entitled to receive it. The Western Cooperage Company reflected in its accounts only the actual amount received from the stock

at the purchase price of ten cents per share and the Western Cooperage Company did not attempt to make any deductions in the years 1938 or 1939 for any additional compensation to John H. Smith.

In this case the Commissioner takes the position that John H. Smith ultimately received capital stock as compensation. The facts in the case show that the most that he received for compensation was only an option to purchase shares at the then market price. There is a distinction between the option and the property acquired under the option as determined by this Court in *Helvering v. San Joaquin Fruit & Investment Co.*, 297 U. S. 496, 56 *Sup. Ct.* 569, 80 *L. Ed.* 824, where this Court said:

> "We hold that the respondent acquired the property on November 30, 1916. The option itself was property, and doubtless was valuable. If it had been assignable, and the lessee had sold it at a profit, taxable gain would have resulted from the sale. But the option is admittedly not the same property as the land. So conceding, the respondent still insists that ownership of the option created an interest in the land. This would not be true of a bare option unconnected with a lease; but we are told that because embodied in the lease the agreement became a covenant real and gave the lessee a species of interest or property in the land. The weight of authority is to the contrary, and no cited California decision supports the position. But even if we should agree that a lessee-optionee acquires, by virtue of the instrument, an equitable interest in the land it would not follow that, within the

> contemplation of the revenue acts, he acquires the property at the date of the option rather than at the date of conveyance. The word 'acquired' is not a term of art in the law of property but one in common use. The plain import of the word is 'obtained as one's own.' Language used in tax statutes should be read in the ordinary and natural sense. In the common and usual meaning of the term the land was acquired when conveyed to the respondent's predecessor."

The Tax Court has now adopted the same rule in the case of *J. Gordon Mack*, 3 *T. C.* 390. The proper rule by which to determine taxable income would not be market value at the time of acquisition of capital assets but would be determined at the time of the sale thereof, and would be the difference between the cost and the sale price.

In 1940 and 1941 John H. Smith sold some of this common stock. He did not attempt to use as a basis for his profit the 1938 or 1939 values (as has been attempted by some taxpayers in some of the reported cases), but he took as a basis in computing his profit the actual amount that he paid therefor of ten cents per share as the agreed price in the option, which was the market price at the time of the option in December, 1934. The *Revenue Act, U. S. C. A., Title* 26, *Section* 113, with respect to the determining of gain or loss on capital assets points out that "the basis of the property shall be the cost of such property." This statute gives a clue

to the intent of Congress with respect to the definition of income, and the Taxpayer in this case has followed that rule in his transactions on the Hawley stock. We venture to suggest that if the Taxpayer had attempted in 1940 and 1941 to use, as a basis in computing his profits, the market value of these stocks in 1938 and 1939, the Commissioner would have strenuously objected thereto and would have insisted that the Taxpayer use the original cost of ten cents per share as the basis of computing his profit or loss.

If any other rule is adopted in this case, the Taxpayer would be required to pay a tax upon a fictitious income which he might or might not ever receive. The market value of these stocks in 1938 went up to $2.50 per share and in 1939 the market values varied between $4.00 per share and $6.75 per share (R. 109-113). It is conceivable that the market value of this stock may drop to a lower figure before the Taxpayer ever disposes of his stock. If it does, he would be in a position of having to pay a tax upon a fictitious profit which he never received. The only sound rule to adopt generally for income tax purposes is that which has already been announced by this Court in the cases above cited, that gains and profits for income tax purposes should only be determined when the profit is converted from capital into money at the time of sale.

This rule was well pointed out by the Circuit Court of Appeals for the Seventh Circuit in *Commissioner of Internal Revenue v. Wood*, 107 *Fed.* (2d) 869, *where* the repossession of real property under a lease was considered, and the Court said:

> "In such cases, common sense dictates that the taxpayer by necessity must wait for his income until there is a conversion into cash or its substantial equivalent. See Eisner v. Macomber, 252 U. S. 189, 207, 208, 40 S. Ct. 189, 64 L. Ed. 521, 9 A. L. R. 1570. Nor does such a construction of the taxing statute work a disadvantage to the Government. The Government will collect its tax, if the taxpayer sells or exchanges the property. On the other hand, if the taxpayer elects to hold the property upon repossession, the Government will tax the entire earnings therefrom, as long as the building is valuable enough to produce net income."

With respect to the several Circuit Court cases upon which the Commissioner has relied, the Court will observe in the facts of each case, the distinguishing characteristics which indicate that the Circuit Courts have not been inconsistent in following the rules already announced by this Court.

In the case of *Crowell v. Commissioner of Internal Revenue*, 62 *Fed.* (2d) 51, stock was given to certain employees "to supplement their cash salaries." No option was involved.

In *Indianapolis Glove Co. v. United States, Ninth Circuit*, 96 *Fed.* (2d) 816, 819, stock was issued in the

name of employees and the employees gave to the corporation their demand notes, but the employees were told that the notes would not be collected and that they were to be paid entirely from stock dividends when such dividends were sufficient for such purpose. The Court found that the parties had agreed that the notes would not be paid and the purpose was to give additional compensation.

In *Mason* v. *Commissioner of Internal Revenue*, 125 *Fed.* (2d) 540, the corporation agreed to sell stock to an employee at $10.00 per share on January 15th of each year, which was part of the compensation set forth in his agreement, and the agreement (contrary to the facts of the instant case) was to be terminated upon his death.

In *Alger Soloman Lumber Co.* v. *Commissioner of Internal Revenue, Fifth Circuit*, 57 *Fed.* (2d) 3, the company transferred 150 shares of capital stock to four of its employees. They were treated as extra compensation and were deducted by the corporation as an expense of doing business. The Commissioner claimed that the transfers were outright sales and not deductible. The stock itself was held in the treasury of the company until they were paid for by the application of cash dividends.

In Olsen v. *Commissioner, Seventh Circuit*, 67 *Fed.* (2d) 726, shares of stock were issued to employees and

held by the compnay under an agreement that the employees who received the stock should remain continuously in the employ of the company for a period of five years, and the company retained the right to repurchase the shares in event of the death of any of the named employees.

In *Robinson* v. *Commissioner of Internal Revenue, Sixth Circuit*, 59 *Fed.* (2d) 1008, the employee had worked for several years at no salary whatever or at a nominal salary, and the stock was sold to him at a price less than market value for the purpose of making it more attractive for the employee to stay with the company.

It is obvious that the decisions in these cases are based upon facts which differ entirely from the facts and conditions of the instant case.

Some reliance is also placed by the Commissioner on the case of *Gibson* v. *Commissioner*, 133 *Fed. Rep.* (2d) 308. In that case the taxpayer, as a stockholder of a company, had an option under which stock could be acquired. She sold the option, and the difference between the option price and the proceeds of the sale of the option constituted income. The writ of certiorari was dismissed in the Gibson case by this Court in the October term, 1943, 88 *L. Ed.* 22. The same rule would apply in this case if John H. Smith had sold his option.

He would have been required to report as income any profit he made over and above the option price. In fact, he did report his full profit in 1940 and 1941 on the sale of any stock sold in those years which he had acquired by reason of his option (R. 93, 94, 95).

The Commissioner also places much reliance upon the decision of the Circuit Court of Appeals for the Sixth Circuit in *Connolly's Estate* v. *Commissioner*, 135 *Fed.* (2d) 64. The facts in the Connolly case strongly indicate that it was the intention of the parties there, by reason of options, to provide additional compensation to employees by way of the increased values which accrued to the stock under the options. From the decision of the Circuit Court the facts which differentiate that case from the instant case appear as follows:

(a) At the time the options were granted the market value of the stock was nearly two and one-half times the option price;

(b) The employer in the Connolly case had voluntarily reduced the fixed salaries of certain employees, including Connolly, during a five-year period preceding the time of the granting of the options, and the designated employees, including Connolly, were then serving the corporation at a rate of fixed compensation greatly disproportionate to the value of their services;

(c) The option entitling the employees to purchase at a price less than the market value was given as ad-

justed compensation for services "heretofore rendered, and as an inducement to said Messrs. Hoagland and Connolly to continue in the employ of the corporation";

(d) The resolution revising the terms of the options recited that the revision was necessary if Hoagland and Connolly, through the medium of options, were to receive purchase rights which "in any real sense" would constitute compensation for valuable services theretofore and then being currently rendered by them to the corporation.

(e) The minutes of the corporation also recited that the services rendered had greatly exceeded in value any compensation received by them, and that the best interests of the corporation would be served by the "continued willingness of these persons to serve the corporation and to exercise in the administration of its affairs the same degree of time, effort and skill as heretofore, and as an inducement to that end," the Board of Directors granted the options "by way of adjusted compensation."

The Court will observe in the Connolly decision, that even at the time the options were granted, the market value of the stock was far in excess of the option price. The market value, at that time, was nearly two and one-half times the option price. The parties recognized that there was an excess value and such excess was in the nature of compensation for services being

presently rendered and to be rendered in the future by the employees. In such a case the employer adjusts his records accordingly and makes the allowable deductions for compensation paid. The Tax Court now declines to follow the Connolly case, as shown by the decision of *J. Gordon Mack*, 3 *T. C.* 390.

In the instant case, however, there was no intent by any of the parties, either John H. Smith or the Western Cooperage Company, to pay additional compensation in 1938 or 1939 to John H. Smith by reason of any values which had accrued to the stock which he had a right to purchase under his option. After the option was given in 1934, the rights of John H. Smith were the same as would be the rights of any stranger to the Western Cooperage Company. He had a contract which he could enforce and under which he could purchase the Hawley stock. He had a contract which he could assign and which could be enforced by his heirs and legatees in the event of his death. These facts preclude any suggestion of compensation in the years 1938 and 1939.

The Circuit Court of Appeals for the Ninth Circuit correctly determined these issues in its opinion in the case below, *Smith* v. *Commissioner of Internal Revenue*, 142 *Fed.* (2d) 818.

That Court followed the reasoning of the Board of Tax Appeals, and the several Circuit Courts of Appeal,

in cases with comparable facts, as well as having followed the substantive rules announced by this Court.

One of the early cases upon this subject is *Delbert G. Geeseman*, 38 *B. T. A.* 258, 264, where the Board of Tax Appeals held that the acquisition of such stock under an option did not constitute the receipt of compensation. In its opinion the Board said:

> "It is true that the prospective purchasers were selected solely because they were valued employees of Continental Can Co., and there is no doubt that the added interest of these employees and the proprietary attitude toward the company which would result from their ownership of the stock constituted one of the motives for the granting of the option. It is equally obvious, however, that the continued employment of the petitioner was not dependent upon the receipt by him of the right to purchase the stock at less than the market price. The terms and conditions of his employment and the compensation he was receiving were in no way changed by the receipt of the privilege of purchasing the stock. Accordingly, the rule stated in the Erskine and Ritter Lumber Co. cases is not applicable here. Furthermore, the price to be paid by petitioner for the stock was substantial and if consideration be given to the language of the offer, the margin of difference between the option price and the current market price at the time the option price was fixed, and to the fluctuation of prices on the stock market during the period in which the offer was made, we do not believe that it can be said that the margin of difference between the offering price and the fair market value of the stock was so great as to require the conclusion that the transaction here constituted the payment of com-

pensation. Cf. Omaha National Bank v. Commissioner, 75 Fed. (2d) 434; Gardner-Denver Co., supra; and Rossheim v. Commissioner, 92 Fed. (2d) 247. Accordingly we are unable to find in the instant case the elements which would indicate that the transaction was not what its form indicates, that is, a purchase of stock by the petitioner with a view to the subsequent realization of profit through dividends or sale or other disposition of the property.

"The conclusion stated makes it unnecessary to consider the petitioner's alternative contentions.

"Decision will be entered for the petitioner."

See also *Gordon M. Evans* v. *Commissioner*, 38 *B. T. A.* 1406.

In the case of *Charles E. Adams*, 39 *B. T. A.* 387, 393, the option price was substantially the same as the market price at the date of the option. In holding that the petitioner did not have income by reason of exercising his option, the Court said:

"The option price was not substantially different from the fair market price at the date of the option. Indeed, the option was at a price slightly higher than the market price at the time. There was undoubtedly connection between petitioner's position as an employee and the granting of the option to him, but it did not amount by any means to the option being granted as compensation for services rendered. In Omaha National Bank v. Commissioner, 75 Fed. (2d) 434, referring to the optionee, it was stated:

"'* * * Undoubtedly he had been accorded this right of purchase because he was a valued em-

ployee of the company and it wished to retain his services * * *.'

"Yet it was held that the option was not compensation for services rendered. The distinction between compensation for services and the granting of an option to employees in order to benefit the company by making the employees more interested in the welfare of the company has, in that case and in Delbert B. Geeseman, Gordon M. Evans, and Rossheim v. Commissioner, all cited above, been fully, and we think soundly, set forth, so that further extended discussion is not here necessary. The situation in the present proceeding offers no difference in principle and no facts to indicate payment of compensation for services rendered, more than in the cases above noted. Indeed, in Gordon M. Evans, supra, there was some language indicating that the agreement was 'designed to compensate those who continue to give to the company their best efforts,' etc., though it was contradicted by other provisions of the agreement; whereas the evidence herein tends throughout, we think, to negative any agreement to compensate for services. Compensation for services was handled on a different basis, dependent upon the earnings of the corporation; the granting of the options to purchase stock had no such limitation. We think the situation amounted to nothing more than an incentive to loyal support of the organization much in the same manner as approved in the cases above cited.

"Respondent's reference to article 22 (a) (1) of Regulations 84 and to similar provisions in prior regulations does not, in our opinion, offer reason for deviating from the opinion already expressed above and in previous cases, for the various cases upon this subject have not permitted, and obviously should not permit, the regulations to add anything to the statute.

"We therefore hold that the petitioner did not have income in the taxable year represented by the difference between the option price and the fair market value of the stock in the corporation.

"Decision will be entered for the petitioner."

See also *Herbert H. Springford*, 41 *B. T. A.* 1001.

In the case of *Gardner-Denver Co. v. Commissioner*, 75 *Fed.* (2d) 38, the taxpayer corporation, in its tax return, endeavored to take certain deductions as compensation to employees, equal to the difference between the subscription price of the stock and the market value. The Commissioner objected to the deductions and was sustained by the Court, which, in its opinion, said:

"Petitioner maintains that while the propositions of employers and the acceptances by the employees are in the form of sale and purchase of the stock, all of the facts indicate that they were not such in essence; but that instead they disclose a purpose of making inducements to the employees for remaining in the employ, and thereby minimizing the labor turnover, to the distinct advantage of the employer, and that such advantage would be and was compensated to the employees by giving them the increase in value of the stock as a further compensation to them for their loyalty and continuous service during the period.

"There have been cases adjudicated where there was involved the question of bonus or additional compensation to employees through transactions whereby they purchased stock from their employers for less than market value. Without citing or discussing them, we think they do not have

application to a situation such as this. Nor are those cases in point where the question was as to the taxability to officers and employees of the excess in value of such stock over what such officers or employees had paid therefor.

"The finding here was that the market value of the stock at the time the agreement was made was substantially the stipulated subscription price to be paid by the employees. While there would thus at that time have been no advantage to the employees in respect to the purchase price, it is plain that any advantage to them consisted in the very easy terms on which they might pay for and acquire the stock.

"If at the time the agreements were made the market value of the stock had been substantially higher than the stipulated price, there might be ground for the contention that, notwithstanding the form of the contract, that difference was in contemplation as a bonus or added compensation to the employees, which, if reasonable, might be treated as such additional compensation or bonus, and deductible accordingly from gross income. See Article 128, Regulations 74 (promulgated under Revenue Act of 1928). *But where, as here, the conveyance of the stock was pursuant to an agreement between employer and employees for conveyance of stock to the employees when a specified price was paid, a subsequent increment in the value of the stock cannot be regarded as contemplated or actual additional compensation to the employees.* And in no event would such subsequent advance in value represent loss or outlay or expense to the corporation itself." (Emphasis ours.)

If the transaction in the instant case represented income to John H. Smith, it would likewise represent expense to, or compensation paid by, Western Cooper-

age Co., but under the decision in the Gardner case this would not be recognized as such compensation.

In the case of *Omaha National Bank* v. *Commissioner*, 75 *Fed.* (2d) 434, there was a contract under which an employee was entitled to buy stock at an agreed price under which the company was to allow credit on the purchase price. The Court held that the difference between credits and market value were not taxable gains until such time as the stock might be sold by the employee. The Court in its opinion said:

> "It is not easy to put out of mind the fact that by 1928 the stock which the taxpayer had purchased in 1918 had become worth far more than the agreed purchase price, and that the taxpayer had a large paper profit as the result of his contract, which profit he could have realized by selling his stock. But if, instead of being worth more than the contract price, the 150 shares received had been worth $2,000, and if the taxpayer had reported in his income tax return the market value of the stock as additional salary instead of the $7,500 credited to him by his employer under the terms of the contract, would the Commissioner then have insisted that the $7,500 was a mere arbitrary credit? We think that he would not. He would very properly have contended that the company, by crediting the taxpayer with $7,500 in 1928, to apply upon the purchase price of the stock, had given him that much additional compensation, and that the taxpayer would not be entitled to a deduction for the loss represented by the difference between the $7,500 paid for the stock delivered to him and the $2,000 which it was worth, until that loss had been realized through a sale of the stock.

"The Commissioner and the Board have treated the transaction here involved as one in which the company in 1928 delivered 150 shares of stock to the taxpayer as additional compensation for services. *They have disregarded the contract.* The additional compensation which the taxpayer received was what he contracted for in 1918 and was the amount credited to him by his employer and with which he paid for the 150 shares of the 500 shares which he agreed to purchase. *The difference between the amount of the credit and the fair market price of the stock was not a taxable gain realized in the year* 1928, *since the stock was not sold by the taxpayer in that year.*

"Concededly, if the company had, without any previous agreement or understanding, credited the taxpayer with $7,500 and delivered to him the 150 shares of stock as additional compensation for his services, the realized gain would be the fair market value of the stock. Rodrigues v. Edwards (C. C. A. 2) 40 F. (2d) 408; Appearl of James R. Lister, 3 B. T. A. 475; Charles R. Johnston v. Com'r of Int. Rev., 8 B. T. A. 992; C. A. Tilt v. Com'r of Int. Rev., 14 B. T. A. 437; Old Colony Trust Co. v. Com'r of Int. Rev. (C. C. A. 1), 59 F. (2) 168. But where the stock was delivered under contract of purchase and the taxpayer became the owner of it because of his agreement to purchase, the difference between what he paid for the stock and what the stock was worth was not a taxable gain. Gardner Governor Co. v. Com'r of Int. Rev., 27 B. T. A. 1171; Durkee v. Welch (D. C. S. D., Calif.), 49 F. (2d) 339; Rose v. Trust Co. of Georgia (C. C. A. 5), 29 F. (2d) 767; Taplin v. Com'r of Int. Rev. (C. C. A. 6), 41 F. (2d) 545; Commissioner of Internal Revenue v. Van Vorst (C. C. A. 9), 59 F. (2d) 677. *It would become a taxable gain in the year that the stock was sold by the taxpayer, provided that the gain*

had not evaporated by that time." (Emphasis ours.)

In the case of *Rossheim v. Commissioner*, 92 *Fed.* (2d) 247, there was an option given to the corporate president to buy stock at approximately its market value, which value at the time of delivery was less than the market value. In holding that the taxpayer had no additional taxable income, the Court said:

> "The Board determined that Rossheim was liable for a deficiency of $45,690.83. It reasoned that since an option contract must be supported by consideration, the consideration must have been services, and that therefore the option amounted to a contract for services. Two members dissented from the majority opinion.
>
> "The majority opinion relied upon the cases of Albert Russel Erskine v. Com'r, 26 B. T. A. 147, and Omaha National Bank et al, Executors, v. Com'r, 29 B. T. A. 817. This latter case has, however, been reversed by the Circuit Court of Appeals for the Eighth Circuit since the Board published its opinion in the case at bar. Omaha National Bank v. Commissioner, 75 F. (2d) 434, 436. In reversing the decision of the Board, Judge Sanborn, speaking for the Court, said: 'Where the stock was delivered under contract of purchase and the taxpayer became the owner of it because of his agreement to purchase, the difference betwen what he paid for the stock and what the stock was worth was not a taxable gain. * * * It would become a taxable gain in the year that the stock was sold by the taxpayer, provided that the gain had not evaporated by that time.'
>
> "The other case relied upon by the Board in its majority opinion is clearly distinguishable from

the case at bar because the option was given for a price far below the actual value of the stock at that time. D. C. Bothwell v. Com'r, 27 B. T. A. 1351, 1356. But in the case before us, it was given at the approximate market price.

"There is no allegation or charge of bad faith with reference to either Rossheim or others connected with this transaction, nor is there any evidence that the option was given for any other purpose than that ascribed by Rossheim, namely, to give him, as an officer of the corporation, an opportunity to acquire a substantial interest therein, if he could effect a 40 per cent increase in the value of the stock

"Since the option was given at the approximate market value of the stock at that time and the sale of it was later made in good faith and in accordance with the terms of the contract, Rossheim did not receive any taxable income in 1928. *His first tax liability arose in* 1929 *and* 1930, *when he sold some of the stock at a profit which he reported.* Rose v. Trust Company of Georgia, 28 F. (2d) 767 C. C. A. 5); Taplin v. Commissioner, 41 F. (2d) 454 (C. C. A. 6); Durkee v. Welch (D. C.), 49 F. (2d) 339; Commissioner v. Van Vorst, 59 F. (2d) 677 (C. C. A. 9); Omaha National Bank v. Commissioner, supra; D. C. Bothwell v. Commissioner, supra.

"The order of redetermination of the Board of Tax Appeals is therefore reversed, and the income tax return of Rossheim is hereby reinstated." (Emphasis ours.)

In the case of *Rose, Collector,* v. *Trust Company of Georgia,* 28 *Fed.* (2d) 767, the Circuit Court of Appeals for the Fifth Circuit also pointed out that where a purchase was made in good faith no taxable income

would be derived until the disposal of the stock, and followed the rule announced in *Eisner* v. *Macomber*, 252 *U. S.* 189, 40 *Sup. Ct.* 189, 64 *L. Ed.* 521, and *McCaughn* v. *Ludington*, 268 *U. S.* 106, 45 *Sup. Ct.* 423, 69 *L. Ed.* 868.

In *Commissioner of Internal Revenue* v. *Van Vorst*, 59 *Fed.* (2d) 677, the Circuit Court of Appeals, Ninth Circuit, had under consideration a purchase of real property from a corporation by the principal stockholder thereof, and in which the question was raised as to the effect of the regulation relative to selling property by a corporation who was shareholder or by an employer to an employee and the Court pointed out that irrespective of the regulation, the statute itself and the Sixteenth Amendment to the Constitution would have to be followed and that there would be no taxable gain to the taxpayer until such time as he disposed of the real property so that his gain could be determined.

In the case of *Hawke* v. *Commissioner of Internal Revenue, Ninth Circuit*, 109 *Fed.* (2) 946, certain stock was purchased by employees and the Court there pointed out that there could be a bona fide sale from an employer to an employee and, if under the facts that it was not intended as additional compensation, any increase in value would not be taxable income under the statute and the Constitution and followed the rule laid

down by this Court in *Palmer* v. *Commissioner*, 302 *U. S.* 63, 58 *Sup. Ct.* 67, 82 *L. Ed.* 50.

The Court will note that under *Treasury Regulation* 101, promulgated under the *Revenue Act of* 1938, *article* 22 (a)—1 treats of the transfer of property by a corporation to a shareholder and by an employer to an employee. The underlying basic principle is the same in both instances. This Court has already determined the issue involved in this case by its decision in *Palmer* v. *Commissioner of Internal Revenue*, 302 *U. S.* 63, 58 *Sup. Ct.* 67, 82 *L. Ed.* 50. In its opinion this Court said:

> "They are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise. The question, then, is whether the distribution which results from the exercise of the rights must be regarded as a dividend if the reasonable value of the property at the time of exercise is more than the purchase price.
>
> "Second. We think that a distribution of assets by a corporation to its stockholders by means of a sale, to which it is committed by appropriate corporate action at a time when their sale price represents their reasonable value, is not converted into a dividend by the mere circumstance that later, at the time of their delivery to stockholders, they have a higher value. The meaning of §115 must be sought in the light of the situations to which it must be applied. It does not purport to withdraw

corporations and their stockholdehs wholly from the operation of §111-113, taxing the profits of purchasers. It cannot be taken to withhold from corporations the power at their own election to effect, by workable means, sales of their assets to stockholders at fair value, subject to that incidence of taxing statutes which usually attends sales. The distribution conte.nplated and defined by it as a dividend is one to be affected by corporate action. Hence, in determining whether a given transaction is 'sale' or 'dividend,' the corporate action which results in one or the other must be scrutinized at the time under which in practice it must be taken.

"The only feasible method by which a corporation of large membership can effect a sale of its assets to stockholders is by tendering to them rights to subscribe, a method whose indispensable first step is the adoption, by appropriate corporate action, of the terms of the offer. Between the dates of the first step and of subscription a substantial period of time must elapse, during which the rights may, and often do, become the subject of violent market fluctuations. Any vendor who offers property for sale at a named price, similarly carries the burden of risk that the property may increase in value between offer and acceptance. If the sale is by executory contract, he also carries the risk between promise and performance. It is an inseparable incident of every sale except those in which conditions admit of payment for the property simultaneously with its tender for sale, a procedure which may not be available to a corporation seeking to sell its property to stockholders.

"It is a solecism to speak of a corporation as distributing its profits for the sole reason that, after it has unavoidably assumed that risk in order to effect a sale of its property to stockholders at a fair price, the property increases in value. Price, which

in the present case is decisive of the issue, must be determined in the light of the situation existing when price is fixed. If the option price is fair when fixed the transaction is a tender for a sale and not for a distribution of profits—a dividend as defined by §115. If, pending execution of the plan, there were no change in value of the stock the transaction would throughout concededly retain its character as a sale. Its character is not altered by the fluctuations of a speculative market, after the corporate action which defines the character of the transaction has been taken.

"When the corporation has committed itself to a sale of its assets to stockholders at present market value the effect on its balance sheet is the same as in the case of other vendors who in various ways assume the risk of rising prices pending the consummation of the sale. In every case purchasers may, as a result of market change, acquire property at less than its value at the date of acquisition. But in the case of the corporation it does not follow that there has been a distribution of its profits. It can hardly be said that profits accrue to a corporation from a fortuitous gain in market value, the benefits of which it has relinquished before the gain occurs. Distribution of profits is neither the purpose nor effect of the action taken by the corporation and there is not adequate basis for saying that the transaction to which the directors committed their corporation was the distribution of earnings, and hence a dividend rather than a fairly conducted sale of corporate property with all the incidents which usually attend a sale when the price is fixed in advance of performance. It is decisive of the present case, so far as the first allotment of United shares is concerned, that distribution of corporate assets, effected by the sale, was not intended to be a means of distributing earnings,

and that the price when fixed represented the fair market value of the property to be distributed."

Likewise, in the present case, a contract was entered into between the Western Cooperage Company and John H. Smith on December 10, 1934, under which the Taxpayer was given the right to purchase 74,377 shares of common stock of the Hawley Co. The price was fixed at ten cents per share, which was equal to or in excess of the then market value. It was a bona fide contract and, if given by way of compensation, was only for services rendered prior to December 1, 1934, and the nature of the compensation was the option only. It was not within the contemplation of the parties that the excess values, if any, which might accrue through the years was to be compensation to the Taxpayer in 1938 or 1939, or any other year. It is necessary to draw a distinction between the option itself and what values actually might accrue under this option in subsequent years. The option itself was the only consideration for any services rendered, and when given, was only given for services rendered prior to December 10, 1934, the date of giving said option. Any increases in value of the common stock covered by the option during the course of years would be only that which would accrue to any owner of property and the gain or loss accruing fom such a transaction can never be adequately determined until a sale is made of the property. Under the

Commissioner's theory in this case, a tax would be imposed upon a fictitious profit or a paper profit fluctuating with the market value. If the Commissioner's theory were adopted in an instance of this kind, or even under these particular facts, there is no certainty that the Taxpayer would be able to sell his stock for the values fixed by the Commissioner at the time of delivery of the stock in 1938 or 1939. One could also assume that in the sale of the stock by the Taxpayer at a price less than the 1939 market value, the Commissioner would not allow a loss computed on the basis of market value in 1939, but would undoubtedly insist upon taxing the profits as a gain with the original cost as a basis.

The Commissioner, in his brief, page 26, indicates that in any particular case where the question is one of fact a determination of the Tax Court should be accepted as final if supported by substantial evidence. Respondent agrees that a finding of fact made by the Tax Court on disputed facts might be conclusive. In the case at bar, however, the facts were not disputed. The Commissioner accepted all of the evidence introduced by the respondent and did not see fit to introduce any evidence on behalf of the Commissioner. The Tax Court, in its findings of fact (R. 21 et. seq.) did not point to any evidence that it was the intention of the parties to compensate the taxpayer by way of increase in value of the stock which might be purchased

under the option. On the contrary the Tax Court in its opinion (R. 34) indicated that the transaction between Western Cooperage Company and John H. Smith was of such a nature that the effect in the taxable year upon petitioner's income tax liability *"involved a construction of law* which in and of itself is difficult." (Emphasis ours). Apparently the Tax Court experienced some hesitation in drawing its conclusions of law. We believe the application of the law to these particular facts was greatly clarified in the opinion written by the United States Circuit Court of Appeals in this case, 142 *Fed.* (2) 818, where the Court very aptly distinguished between the option agreement itself which was given as compensation, and the increase in value which accrued to the stock before the exercise of the option, which was not compensation. Under these circumstances it was very proper for the Circuit Court of Appeals to reverse the Tax Court.

The Commissioner asserts in his brief on page 10 that under the Treasury Regulations there is a strong presumption that all gains flowing from the employer-employee relationships are in the nature of compensation. We disagree with this assertion and if such a rule be adopted much confusion would result in taxation, as well as in the relationships between employer and employee. Under such a theory contractual rights between employer and employee would be prohibited

by reason of fear of uncertainties in taxation. Congress intended no such presumption or restriction.

In the field of taxation it has not been the practice of courts to read presumptions into the statutes or regulations. The only duty of the court is to interpret the intent of Congress as expressed in the statutes. Where there is a reasonable doubt as to the meaning of a taxing act it has uniformly been construed most favorable to the taxpayer. *Gould v. Gould* 245 *U. S.* 151, 38 *Sup. Ct.* 53, 62 *L. Ed.* 211. *White v. Aronson*, 302 *U. S.* 16, 58 *Sup. Ct.* 95, 82 *L. Ed.* 20.

The Commissioner believes that in a transaction of this kind, stock purchased under an agreement by an employee should be taxed as ordinary income. The Revenue Act, however, has set forth quite definitely the proper method of computing gains and losses on the acquisition and sale of capital assets. If it was the intention of Congress to tax capital gains as ordinary income, Congress certainly would have so provided in the statute. The statute, as enacted by Congress, permits capital gains and capital losses to be computed on a relatively comparable basis which is fair to all taxpayers. The theory of the Commissioner to tax such income as ordinary income in cases where stock is purchased under option agreements, would be grossly unfair to taxpayers, for the reason that they could not

take their capital losses on a comparable basis and be placed in a different classification from all other taxpayers with capital transactions.

We submit that the Commissioner in his brief does not point to any evidence in the record before the Tax Court which would indicate that the increase in value of the Hawley stock, as distinguished from the option agreement itself, was intended as compensation to John H. Smith. On the contrary the undisputed record indicates that the option itself was the only compensation given, and that was given in 1934. No further compensation was intended in 1938 or 1939 or any other year.

CONCLUSION

This Court should adopt the rule which became effective by the decision of the Circuit Court of Appeals in this case. The adoption of such a rule would avoid the use of fiction in determining the gains or losses of taxpayers and would require the gains or losses to be computed at the time of sale of a capital asset and would always require that the original cost thereof be used as a basis for computing the tax. This would prevent the use of devices by taxpayers with the apparent expectation of minimizing tax liability. It would prevent taxpayers from using a high base upon the exercise of an option. It would also enable the tax to be computed upon definite certainties and would not unjustly impose a tax upon a taxpayer by reason of fluctuating market values. Such a rule would also prevent corporations from taking unjustified deductions represented by high market value of securities for which they actually received less than the market value. Such a rule would also enable taxpayers to make their returns and pay their tax at a time when they actually received the money from the sale of capital assets, and are thereby enabled to pay the tax out of profits, if any.

We respectfully submit that the decision of the Circuit Court of Appeals for the Ninth Circuit is correct and should be affirmed.

Respectfully submitted,

Clarence D. Phillips,
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Of Counsel:
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January, 1945.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

No. 371

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

against

JOHN H. SMITH,

Respondent.

MEMORANDUM OF AMICI CURIAE IN SUPPORT OF PETITION FOR REHEARING

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March 20, 1945.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,* *against* JOHN H. SMITH, *Respondent.*	No. 371

MEMORANDUM OF AMICI CURIAE IN SUPPORT OF PETITION FOR REHEARING

This memorandum is filed because of the far-reaching effects and implications of this Court's opinion (delivered by the Chief Justice on February 26, 1945) beyond the confines of its particular facts, and especially because of a fundamental misunderstanding of those particular facts. It is submitted that this Court should grant the petition for rehearing and set a date for reargument.

Grounds for Rehearing.

The reasons for our submission are two-fold:

1. *This Court in its opinion inadvertently stated material facts in a manner at variance with the findings of the Tax Court. Such facts have an important bearing upon the decision.*

(a) The Tax Court found that the option was exercised in its entirety, and all the stock paid for, in March, 1938, at a time when the fair market value of the stock was $2.50 a share (R. 27, 29, 19, 20). This Court inadvertently states that the option was exercised and the stock was paid for partly in 1938 and partly in 1939. In 1939 the fair market value of the stock averaged about $5.90 per share. This Court states in its opinion that the compensation was "derived from exercise of the option" and was measured by the value of the stock over the option price "whenever the option was exercised". On that theory, the compensation could not exceed the excess of $2.50 per share over the option price.

(b) The Tax Court found that the option itself was given as compensation for services (R. 24, 33). The Tax Court did not find (as assumed by this Court) that the option was worthless or had no fair market value when received by the employee. There was testimony that the value of the option was small, but none that it was worthless. The Tax Court failed to make any finding on that material question. A long-term option (in this case running for over five years) to purchase stock at more than the market value of that stock when the option is given does have value, as is shown by the quotations for such options contained in Appendix A hereto. This case should be remanded to the Tax Court for a finding as to the value of the option on the date of its receipt.

2. This Court should further clarify the effect of its decision in this case upon its decision in Palmer v. Commissioner, 302 U. S. 63, which has been generally regarded as

holding that the receipt of an option granted at or above the current market price cannot result in the realization of income.

In the *Palmer* case, this Court said that options are at most "continuing offers, potential sources of income * * * through sale or the exercise of the rights." (302 U. S., at p. 71).

I. This Court's affirmance of the Tax Court's decision was based on an erroneous understanding of the facts.

(a) Short Restatement of the Facts.

The respondent was employed by the Western Cooperage Company (hereinafter called Western). Western, under a reorganization plan of the Hawley Pulp and Paper Company (hereinafter called Hawley) was to have the right to receive certain shares of Hawley stock. In December, 1934, Western gave an option to the respondent to purchase, on or before January 1, 1940, at a price of $7,437.70 "the right to receive" 74,377 shares of Hawley (R. 25). The option price was accordingly 10¢ a share. At the time the option was given the market value of Hawley stock did not exceed 10¢ a share (R. 28).

The option was given to the respondent "in consideration of services rendered" by the respondent prior to December 10, 1934 (R. 25). It was completely assignable, and could pass by will or by intestacy.

In March, 1938, the respondent exercised his option *in its entirety* and on March 21, 1938, paid Western $7,437.70 for 74,377 shares of Hawley (R. 27, 19, 20). Western did not have possession of the Hawley stock and delivery was made to the respondent from the depositary under the re-

organization plan of Hawley pursuant to direction of Western (R. 28, 143).

Western in its 1938 income tax return reported $7,437.70 as a capital gain with the explanation "Sale of our right to receive 74,377 Shares Common Stock of Hawley Pulp and Paper Company" (R. 28).

The depositary under the reorganization plan delivered 33,759 shares of Hawley to the respondent on March 19, 1938, and delivered an additional 12,374 Hawley shares to the respondent at various dates in 1939 (R. 28).

In March, 1938, at the time the option was exercised in its entirety and the first 33,759 shares delivered pursuant thereto, the stock of Hawley had a fair market value of $2.50 per share (R. 29).

The 12,374 shares delivered to the respondent in 1939 had an aggregate fair market value of $72,709.38 at the dates of their delivery, or an average fair market value per share of about $5.90 (R. 29).

The decision of the Tax Court as to the amount of the income tax deficiency (as opposed to its opinion) measured the compensation with respect to the 33,759 shares delivered in 1938 as the difference between 10¢ and $2.50 per share, but measured the compensation with respect to the 12,374 shares delivered in 1939 as the difference between 10¢ and approximately $5.90 a share.

(b) The Misunderstanding of this Court as to the Date of Exercise of the Option.

The Tax Court stated in its opinion that the petitioner received compensation when he *exercised* his option and Western parted with the right to receive stock which had a much greater value than the option price. The Tax Court states:

> "When petitioner [respondent here] exercised his option and received the stock, Western parted with the right to receive stock which had a much greater value than the option price. Under the reasoning of the *Connolly* case, petitioner received compensation to the extent of the differential" (R. 33).

This Court said that the Tax Court found

> "implicitly that the compensation referred to was the excess in value of the shares of stock over the option price whenever the option was exercised."

This Court also said that

> "the compensation [was] to be derived from exercise of the option after the anticipated advance in the market price of the stock."

Accordingly, the theory of the above quoted portions of the opinions is that the respondent's compensation is measured by the difference between the value of the stock when Western parted with the right to receive it, and the option price. However, Western transferred the right to receive the Hawley stock to the respondent in March, 1938, when he exercised his option in its entirety and paid for all of such stock (R. 27, 19, 20). The option was to purchase from Western the "right to receive" the Hawley stock. That was all done in 1938 (R. 148). The fair market value of the Hawley stock at that time was found to be $2.50 per share. Accordingly, the compensation derived from the option with respect to the 46,133 shares of Hawley delivered to the petitioner by the depositary in 1938 and 1939 could not have exceeded $115,332.50 [46,133 x $2.50], less $4,613.30, the amount paid therefor. However, the deficiency found by the Tax Court (which was affirmed by this Court) is based upon aggregate compensation for 1938

and 1939 of $152,682.58, less $4,613.30, which takes into account the rise in the value of the Hawley shares after Western had completely parted with its right to receive such shares on the exercise of the option in March, 1938.

This Court states, however:

> "In two later tax years, when the market value of the stock was greater than the option price, respondent exercised the option, purchasing large amounts of the stock in each year."

And again:

> "In that [1938] and the following year respondent, by the exercise of his option, acquired from Western large amounts of the stock on payment of the option price."

As such an assumption of the facts would be the only possible way in which the Tax Court's decision could be made in any way consistent with the theory of the opinions, it is not surprising that this Court thought the facts were as it had stated them. However, as pointed out above, it is clear that the respondent exercised his option in 1938 and paid for all the stock in 1938 (R. 27, 19, 20). There was no longer any option after that date. After the exercise of the option and the payment for the stock in March, 1938, Western had no further interest in the transaction. Deliveries were made not by Western but by the depositary under the reorganization plan of Hawley.

This Court indicated that (assuming that the option had no value when received, which assumption we challenge) "the compensation referred to was the excess in value of the shares of stock over the option price whenever the option was exercised". If that be the true rule, since

the value of the Hawley stock was only $2.50 a share when the option was exercised, the *decision* (as opposed to the opinion) of the Tax Court, which includes as compensation a much greater amount, cannot properly be affirmed by this Court.*

(c) The Misunderstanding of this Court with Respect to the Value of the Option when Given.

The opinion and the findings of fact of the Tax Court state that it was the *option* which was given as compensation for services. The Tax Court said (R. 33):

> "It is indisputable that Western gave the option to petitioner [respondent here] as compensation for services rendered in effecting the reorganization plan of Hawley."

No finding was made by the Tax Court with respect to the value of that option. Accordingly, the Tax Court failed to make a finding on what this Court's opinion considers to be a most material fact. If the option was given as compensation (as the Tax Court found) the fair market value of the option when received would measure that compensation. The Treasury Regulations so provide:

> "If services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income." (Treasury Regulations 101, Article 22(a)-3).

This Court appears to have noted in its opinion the inconsistency between the Tax Court's finding that it was the

*Assuming that the respondent was on the cash basis (as almost all individuals are) questions as to the proper year of the taxation of the difference between 10¢ and $2.50 per share would be briefed on the reargument

option itself which was given as compensation and its opinion (as construed by this Court) to the effect that the compensation was derived "from exercise of the option after the anticipated advance in market price of the stock." This Court points out that an option may be considered to be "property" in the hands of the option holder, citing its own decisions to that effect.*

However, this Court assumes that the option had no value when received, an assumption which appears to be negatived by the very fact that it was given as compensation. Corporations are not presumed to give valueless property as compensation.

Moreover, this Court, we submit, was under the misapprehension that a long-term option to purchase stock at or above the market price of the stock when the option is given has no value. That is not so. It is clear that a long-term option (in the instant case, for over five years) to purchase at the market when the option is given does have a value, as is shown by the list of quotations of options to purchase at *more* than present market value which is contained in Appendix A to this memorandum.

A failure by the Tax Court to make a finding as to whether the option had value should not be considered by this Court as a finding that the option had no value, particularly where it is apparent that such an option does have value.

This Court's decision in *Palmer* v. *Commissioner*, 302 U. S. 63, has generally been regarded as a holding that

*That an option to purchase stock is property is also supported both by Treasury Ruling and by Congressional Committee Reports. See G. C. M. 23677, 1943 C. B. 370, and the report of the Committee on Ways and Means with respect to the Revenue Bill of 1942, Report No. 2333 (77th Cong., 2nd Sess.) p. 98.

income may not be realized from the mere receipt of an option granted at the current market price of the stock. If this Court intends to overrule that aspect of the *Palmer* case, an opportunity should be given to the respondent to present evidence as to the value of the option when received, in order that the Tax Court may make a finding with respect to a point which was apparently not considered material at the time of the hearing.

II. This Court should clarify the extent to which its decision in this case overrules its decision in Palmer v. Commissioner.

The Treasury Regulations have for many years treated as analogous situations cases where a corporation sells property or gives options to its shareholders and cases where it sells property or gives options to its employees. The instant case deals with the latter situation. *Palmer* v. *Commissioner*, 302 U. S. 63, dealt with the former.

The *Palmer* case arose under the Revenue Act of 1928. At that time Treasury Regulations 74, issued under the Revenue Act of 1928, contained the following sentence in Article 51:

> "Where property is sold by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, such shareholder of the corporation or such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value."

The *Palmer* case involved options to purchase stock of The United Corporation (hereinafter called United) which was owned by The American Superpower Company (here-

inafter called Superpower). In 1929, Superpower gave its shareholders options to purchase United stock at $25 a share. Such options (called "rights") were received by the shareholders about January 31 and had to be exercised by February 15. It was found by the Tax Court (then the Board of Tax Appeals) that on the day the options were given the fair market value of United stock was $25 a share. However, rights to purchase United stock (each right authorizing the purchase of one-half share) sold at that time for approximately $12 apiece, so that the right to purchase a full share of United at $25 a share was in itself worth approximately $24.

The taxpayer in the *Palmer* case was a shareholder of Superpower who received options to purchase United stock. The Commissioner of Internal Revenue ruled that such options were dividends and assessed a deficiency against the shareholder based on the market value of the options when the shareholders were first entitled to exercise them.

This Court, however, stated that the rights

> "are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise" (302 U. S. at p. 71).

This Court then went on to hold that the shareholder realized no income upon the exercise of the option even though the United stock was worth more than $25 a share when the option was exercised, saying:

> "Second. We think that a distribution of assets by a corporation to its stockholders by means of a sale, to which it is committed by appropriate corporate action at a time when their sale price represents

> their reasonable value, is not converted into a dividend by the mere circumstance that later, at the time of their delivery to stockholders, they have a higher value. * * * It is a solecism to speak of a corporation as distributing its profits for the sole reason that, after it has unavoidably assumed that risk [that the property may increase in value] in order to effect a sale of its property to stockholders at a fair price, the property increases in value. * * * In every case purchasers may, as a result of market change, acquire property at less than its value at the date of acquisition. But in the case of the corporation it does not follow that there has been a distribution of its profits. It can hardly be said that profits accrue to a corporation from a fortuitous gain in market value, the benefits of which it has relinquished before the gain occurs." (302 U. S. at pp. 71-73).

Applying the above language to the analogous situation where an option is given to an employee rather than to a shareholder, it would appear:

1. That the mere receipt of an option to purchase property at current market does not result in the realization of income, unless it was intended as a distribution from the corporation to the employee.

2. That, if when the option is given the option price is not less than the market price, there has been no distribution by the corporation upon the exercise of the option even though when the option is exercised the market price is greater than the option price. This is because a corporation cannot be deemed to distribute an appreciation in value which it has contracted away before that appreciation occurred. Accordingly, if the appreciation in value is not deemed to be a distribution from the corporation [the

employer[it is difficult to see how it can be deemed to be compensation to the employee.

Difficulties Resulting from a Complete Abandonment of the Palmer Rule.

As is pointed out above, the option in the instant case and the option in the *Palmer* case both had a value when received. The *Palmer* case holds that neither the receipt of such an option nor its exercise results in the realization of income. The opinion in the instant case indicates, although it does not decide, that the receipt of such an option may result in the realization of income, if the option has a value when received, and is given as compensation. That seems logical and correct.

However, when the option has no value when received (a situation which in practice is most unlikely to arise), this Court apparently believes that later accretions in value received by the employee pursuant to the option are the measure of the compensation.

Once this Court lays down the principle that, if property be given as compensation, the employee may be taxed not only on the value of the property at the time it is received but on all later accretions thereto which are deemed also to be intended as compensation, it has created possibilities for great confusion.

Suppose, for example, that a corporation gives its employee as compensation some stock which is worth 1¢ a share but which it is hoped will appreciate in value. Is it open to the Commissioner to tax the accretions in value to that stock each year as compensation to the employee on the ground that his employer intended such accretions to be compensation? That same problem arises on a sale of the stock. Can such a sale be the receipt of compensation?

Would the problem be different if the stock were worth $100 per share when received by the employee as compensation?

How can an employer pay compensation out of an accretion in value to which it never had any right? In the case of a completely assignable option, as in the instant case, the decision as to who is to receive the accretion in value rests wholly in the hands of the employee after the option is given. It is up to him to decide whether he wishes to keep the option or to sell it and with it the right to receive the appreciated stock. Certainly, if the employee sells the option to an outsider in an arm's length transaction, and that third party exercises the option, the corporation cannot be said to have paid any compensation at the time the option is exercised. Moreover, the amount which the employee receives for the option upon his sale to a third party would not necessarily correspond in any way with the value of the stock at the time (perhaps years later) when the third party exercises the option and the corporation gives such third party the right to receive the stock.

Similar difficulties would occur where the employee dies and the option is later exercised by a third party, a transferee of his estate.

The answer to the above questions appears to us to lie in the well-reasoned opinion of the Chief Justice in the *Palmer* case, in which this Court very clearly sets forth that accretions in value of property after an option to sell it has been given by a corporation cannot be distributions by the corporation, on the logical ground that the corporation lost its interest in such accretions by giving the option.

To take the instant case as an example, Western lost all interest in any accretion over 10¢ a share in 74,377 shares of Hawley when it gave the option at that price to the re-

spondent in December, 1934. That option had a value, and it would appear to be proper to distinguish the *Palmer* case to the extent of holding that compensation was given to the respondent in the amount of that value.

It appears to us to be wholly incorrect to say that Western paid any compensation to the respondent when the option was exercised in March, 1938. Western had had no interest in the accretion in value on those 74,377 shares since December, 1934.

Moreover, it is completely illogical to go beyond the date of the exercise of the option and permit the respondent to be taxed on increases in value after he had exercised the option and paid for the stock. We believe that this Court did not intend so to hold, and its opinion appears to say that the exercise of the option is the controlling date. All the respondent was entitled to under the option was the "right to receive" the Hawley stock. That he got in its entirety in 1938 upon the exercise of the option and complete payment thereunder. After that the option was gone.

It is respectfully submitted that this Court should grant a rehearing and set a date for reargument, in order that the inconsistency between the decision of the Tax Court (which this Court affirmed) and the opinions both of this Court and of the Tax Court may be corrected.

Respectfully submitted,

ROSWELL MAGILL

GEORGE G. TYLER

As *Amici Curiae*,

15 Broad Street,

New York 5, N. Y.

March 20, 1945.

APPENDIX A

Quotations of Stock Option Warrants to Purchase Stock at More than Market*

A. C. F.-Brill Motors Company

Warrant to purchase 1 share of common at $12.50 to 1/1/50
and at $15.00 to 1/1/55

New York Times 3/18/45	common	11⅝
	warrant	5¼

American & Foreign Power Co. Inc.

Warrant to purchase common at $25 per share unlimited

New York Times 3/18/45	common	3⅝
	warrant	7/16

Atlas Corporation

Warrant to purchase common at $25 per share unlimited

New York Times 3/18/45	common	16⅜
	warrant	2⅞

Baldwin Locomotive Works

Warrant to purchase common at $15 per share to 9/1/45

The Commercial and Financial Chronicle 2/17/42	common	13⅜
	warrant	3½

Colorado Fuel & Iron Corp.

Warrant to purchase common at $35 per share to 2/1/50

New York Times 3/18/45	common	27¼
	warrant	6⅛

Commonwealth & Southern Corporation

Warrant to purchase common at $30 per share unlimited

Wall Street Journal 3/8/45	common	⅞
	warrant	1/16

Electric Power & Light Corporation

Warrant to purchase common at $25 per share unlimited

Wall Street Journal 3/8/45	common	5
	warrant	11/16

Manati Sugar Company

Warrant to purchase common at $12.50 per share to 11/5/47

Wall Street Journal 3/8/45	common	10
	warrant	2⅝

*The terms of the warrants are taken from Moody's Manual of Investments—1944, except for the A. C. F.-Brill Motor Company warrants, the terms of which have been taken from Sinclair-Murray, Capital Changes Service.

MERRITT-CHAPMAN & SCOTT CORPORATION

Warrant to purchase common at $30 per share unlimited
The Commercial and Financial Chronicle 1/27/42 common 5½
warrant ½

NEW YORK CITY OMNIBUS CORPORATION

Warrant to purchase 2½ common at $17.50 per share to 3/1/47
The Commercial and Financial Chronicle 1/27/42 common 13½
warrant 2⅜

RADIO-KEITH ORPHEUM CORPORATION

Warrant to purchase common at $15 per share to 1/31/50
New York Times 3/18/45 common 8½
warrant 1½

RICHFIELD OIL CORPORATION

Warrant to purchase common at $20 per share to 3/14/47
Wall Street Journal 3/8/45 common 13½
warrant 1⅜

TRI-CONTINENTAL CORPORATION

Warrant to purchase 1.22 common at $18.46 a share unlimited
Wall Street Journal 3/2/45 common 6⅞
warrant 1⅜

UNITED CORPORATION

Warrant to purchase common at $27.50 per share unlimited
Wall Street Journal 3/8/45 common 1¾
warrant ⅛

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MAR 17 1945
CHARLES ELMORE CROPLEY

No. 371

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

vs.

JOHN H. SMITH, *Respondent.*

RESPONDENT'S PETITION FOR REHEARING AND MOTION TO WITHHOLD ISSUANCE OF MANDATE

CLARENCE D. PHILLIPS,
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Portland, Oregon.

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

vs.

JOHN H. SMITH, *Respondent.*

RESPONDENT'S PETITION FOR REHEARING

Comes now the Respondent in the above entitled cause and respectfully petitions the Court for a rehearing of the above cause and the reconsideration of the record and decisions herein upon the following grounds:

1. The opinion of the above Court appears to be premised upon a purported finding of fact made by the Tax Court. The Circuit Court of Appeals, in its decision and after scrutiny of the record, held that there was no "basis for finding that the option was intended to enable Petitioner to make a 'bargain purchase'."

Respondent respectfully submits that the Tax Court made no finding of fact but ruled only upon the question of law. The opinion of the Tax Court (R. 29) states that the Respondent's failure to report income in

the taxable years "was due to an honest mistake of law" and also stated (R. 34):

> "The transaction between Western and Petitioner was of such nature that the effect in the taxable year upon Petitioner's income tax liability *involved a construction of law* which, in itself, is difficult. We are satisfied from the record that Petitioner's failure to report the excess of the fair market value of the stock over the option price as income was due to an honest misunderstanding of law and not to negligence or intentional disregard of regulations." (Emphasis ours.)

We respectfully submit that this Court should re-examine the testimony in this case. From an examination of the testimony, we do not see how the Court can come to any other conclusion than that the parties intended that the option itself should be the sole remuneration and that any increase in value of the stock should not be compensation.

2. The evidence in the record conclusively shows that the option itself was the only form of compensation given. The services of John H. Smith as an employee subsequent to 1934 were in no way connected with this option (R. 74, 75, 95). The testimony shows that the option agreement between these parties was just the same as if it were between strangers (R. 95). Even on cross-examination the testimony of Mr. Smith was as follows (R. 107):

"Q. Now, *the option*, however, to buy the stock was given to you for services rendered, is that correct,—is it not?

"A. That is correct." (Emphasis ours.)

The record unqualifiedly shows that the Western Cooperage Company did not look upon the increase in values as compensation to Mr. Smith. The testimony of M. D. Carter, accountant for Western Cooperage Company (R. 133, 134) is as follows:

"Q. And in the year 1938 was there any reflection in the records of the Western Cooperage Company of any income or salary or compensation paid to Mr. Smith which in any way reflected the value,—market value, or any other value of this common and second preferred stock? A. No.

"Q. Was there any deduction taken in any way in their income tax return for 1938 or 1939? A. There was not.

"Q. Representing any form of compensation to Mr. Smith by reason of his purchase of this stock? A. No, there was not."

The uncontradicted testimony in the case therefore shows that neither party intended that any increase in value was to be compensation. It is significant in this case that the employer did not take any deduction on its own tax return for the difference between the option price and the market value as compensation paid to an employee. If it was compensation to John Smith, it

would also be deductible as an operating expense by the employer.

3. The opinion of the above Court indicates that the Court viewed this transaction as being two separate purchases, one in 1938 and one in 1939. The record shows that from December 10, 1934, to March 21, 1938, John H. Smith had only an option to purchase the right to receive. On March 21, 1938, he exercised this option and thereby *purchased in 1938* all of the stock which he thereafter received over a period of four years (R. 87, 88, 89, 90). The deliveries of these shares in the respective years were as follows:

1938	33,759 shares
1939	12,404 "
1940	17,356 "
1941	10,858-1/24 shares
Total	74,377-1/24 shares

As of March 21, 1938, John Smith paid the full purchase price of $7,437.70 as the consideration for all of the shares. After March 21, 1938, John H. Smith no longer held an option, but was the absolute purchaser of the shares in the year 1938. The only thing remaining to be done was the delivery thereof, which was done in the respective years. The tax deficiencies for 1940 and 1941 were not considered in this record as they had not yet been proposed at the time of the trial before the Tax

Court. The Petitioner submits that if the decision of the Tax Court is not to be reversed, at least it should be modified, to show this transaction as consummated in the year 1938 when the total purchase price was actually paid. In other words, if a tax is to be imposed by reason of the increase in value, the entire tax should be imposed in the year 1938 and not spread over the years 1938, 1939, 1940 and 1941. At least in 1938 John H. Smith became an absolute purchaser as distinguished from an optionee.

At the time Mr. Smith exercised the option in 1938 by payment of the full option price, he was vested with the right to receive the stock covered by the option; he also elected to and did purchase such stock. It is true that he did not then take delivery of all of such stock, but he then *purchased* said stock and acquired the right to have all of such stock delivered to him. At the time of the exercise of the option, Mr. Smith exhausted the option and terminated its value, and, under the theory as set forth in the opinion of this Court, the compensation to Mr. Smith should be the value of the stock acquired at the time of the exercise of the option, less the option price paid by Mr. Smith.

The Western Cooperage Company should be permitted, under such theory of the opinion of this Court, to claim a deduction in its operating expenses, for the

compensation paid Mr. Smith, which would be the value of the stock, at the time of the exercise of the option, less the option price thereof.

But, somewhere, there must be a cut-off date for tax accounting with respect to both the tax returns of Mr. Smith, the employee, and of the Western Cooperage Company, the employer, and that date must be the same date for each of such returns. The Circuit Court of Appeals found that such cut-off date was the date of the option. The opinion of this Court, unless modified, would determine that such cut-off date was, for Mr. Smith, the date of the delivery of each parcel of stock, long after the termination by exercise, of the option. If such date is the proper cut-off date for Mr. Smith, then it must also follow that such date is the proper cut-off date for his employer. Whatever is charged on that date against Mr. Smith as income for services must also be allowed, under such opinion, as a deduction, as of the same date, in the return of his employer the Western Cooperage Company, as compensation for his services as an employee.

Certainly that cut-off date should not be extended beyond the date of the termination of the option, which option represented the only value given to Mr. Smith for his past services. To leave this matter open, with no assurance as to the date of the cut-off in the respec-

tive returns of Mr. Smith, the employee, and of the Western Cooperage Company, the employer, will lead to all kinds of complications. For instance, let us assume that the stock was worth $10.00 per share at the date of the exercise of the option, and that war-time income taxes then prevailed; would Mr. Smith be permitted to put off the day of delivery to him of the stock until post-war lower taxes might be in effect? Or, let us assume that the value of the stock was higher, at the time of the exercise of the option, than justified in the forecast and opinion of Mr. Smith; would he be permitted to delay delivery until the value might be reduced to what he considered to be a justifiable value as a tax base?

Or, assuming that Mr. Smith, after the exercise of the option, sold such stock and delivery to his purchaser was indefinitely delayed; what would be the cut-off date in the return of Mr. Smith and what would be the cut-off date in the return of his employer, Western Cooperage Company?

This line of argument, if logically pursued in the application of the theory of the opinion of this Court, must lead to the following conclusions, to-wit:

(a) That the option was the "value" which was delivered to Mr. Smith for his past services;

(b) That the value of the stock *at the time of the exercise of the option*, less the option price

thereof, represented the dollar and cents value of that option;

(c) That at the time of the exercise of said option, Mr. Smith was chargeable with the then value of the stock purchased in the exercise of said option as compensation for his services, and the Western Cooperage Company was likewise then entitled to take such value as a deduction in its operating expenses.

4. The Court, in its opinion, made no mention of the fact that this option ran, not only to John H. Smith, but to his heirs and assigns. This option contract was assignable. If John H. Smith had assigned this contract, the increase in value certainly could not have been considered as compensation in the hands of his assignee. If John H. Smith had died prior to the time he exercised his option, his heirs could have enforced the option. It cannot be said that his heirs were employees or that any increase in value was compensation to his heirs. This portion of the agreement is a further manifestation of the intent of the parties that the increase in value was never intended as compensation by any of the parties to the transaction.

5. The Court, in its opinion, made no mention of the distinction to be drawn under the Tax Act between one who purchases from his employer pursuant to an "arm's length" transaction and a similar "arm's length" transaction between strangers. In this case the Respondent made an "arm's length" transaction with his

employer under which the increase in value was not intended as compensation and the Respondent is taxed upon the increase in value as ordinary income. An identical transaction between two strangers would result in tax, not at the time of acquisition, but at the time of sale and the tax would be on the basis of a capital gain or loss. We respectfully submit that this is not only unjust to this taxpayer but is adding confusion to the equitable administration of the tax law.

6. We also respectfully submit that the revenues of the Government will be greatly impaired by this decision for the reason that corporate employers who have or will give to employees options similar to the one in the instant case, will welcome the opportunity to have a further deduction from their corporate income and thereby reduce the corporate tax, the maximum rates of which are in excess of those on personal incomes.

CONCLUSION

We respectfully submit that the Court should re-examine the testimony in this case and grant a rehearing herein. In the event that the decision of the Circuit Court of Appeals cannot be affirmed, this Court at least should modify the decision of the Tax Court and hold that the actual purchase of all of the shares referred to in the option was consummated in 1938, when the purchase was actually made by payment of the consideration therefor, and all of the gains on the 74,377 shares taxed in 1938. In the alternative, we respectfully submit that the matter should be remanded to the Tax Court for retrial. This would enable the Tax Court to consider at the same time, the tax deficiencies for 1940 and 1941 in conjunction with 1938 and 1939, and thereby consider the whole transaction.

Respectfully submitted,

CLARENCE D. PHILLIPS.

Of Council:

GRIFFITH, PECK, PHILLIPS & NELSON,

March, 1945.

I, Clarence D. Phillips, attorney for Respondent in the above cause, do hereby certify that the foregoing petition for Rehearing is presented in good faith and not for delay and that this certificate is made pursuant to Rule 33 of the Rules of the above Court.

CLARENCE D. PHILLIPS,
Attorney for Petitioner.

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

vs.

JOHN H. SMITH, *Respondent.*

MOTION TO WITHHOLD ISSUANCE OF MANDATE

Respondent herein moves the Court for an Order enlarging the time for the issuance of mandate and that the issuance of mandate be withhled until the disposition of the within Petition for Rehearing.

Attorney for Respondent.
CLARENCE D. PHILLIPS.

SUPREME COURT OF THE UNITED STATES.

No. 371.—October Term, 1944.

Commissioner of Internal Revenue, Petitioner, vs. John H. Smith.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[February 26, 1945.]

Mr. Chief Justice Stone delivered the opinion of the Court.

Respondent's employer gave to him, as compensation for his services, an option to purchase from the employer certain shares of stock of another corporation at a price not less than the then value of the stock. In two later tax years, when the market value of the stock was greater than the option price, respondent exercised the option, purchasing large amounts of the stock in each year. The question for decision is whether the difference between the market value and the option price of the stock was compensation for personal services of the employee, taxable as income in the years when he received the stock, under § 22(a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and § 22(a) of the Internal Revenue Code, 26 U. S. C. § 22(a).

Upon a petition to review the Commissioner's finding of a tax deficiency against respondent for those years, the Tax Court sustained the Commissioner. The Court of Appeals for the Ninth Circuit reversed, 142 F. 2d 818, holding that there was no finding and no evidence to support a finding, that the option was intended to enable respondent to make a "bargain purchase" or that the stock was issued to him as compensation for services. It concluded that the exercise of the option was a mere purchase of a capital investment which could result in taxable income only upon sale of the stock. We granted certiorari, 323 U. S. —, on a petition which asserted conflict of the decision below with the decision of the Court of Appeals for the Sixth Circuit in *Connolly's Estate v. Commissioner*, 135 F. 2d 64.

The Tax Court found that for many years, and at all relevant times, respondent was employed by the Western Cooperage Com-

pany. In 1934 Western took over the management of the Hawley Pulp and Paper Co. pursuant to a plan for its reorganization. Hawley was then in financial difficulties, with an indebtedness amounting to $2,790,150. Under its contract with Hawley, Western was to retire annually a certain amount of Hawley's indebtedness. In the event of success in this undertaking, and when the amount of Hawley's indebtedness had been reduced by the sum of $1,400,000, Western was to receive specified amounts of the Hawley Company's capital stock as compensation for the services thus rendered.

Respondent, in the course of his employment by Western, was active in the reorganization of the Hawley Company. As compensation for his services, the president of Western, in December 1934, gave respondent an oral option to purchase a part of the Hawley stock, to be acquired by Western under its contract. This action was confirmed by resolution of the Board of Directors of Western, pursuant to which Western, as of December 10, 1934, and "in consideration of services rendered" by respondent prior to that date, agreed in writing to sell to respondent at his option, at ten cents a share, a specified proportion of such shares of common stock as it might be entitled to receive under its contract with Hawley. On March 18, 1938, Western became entitled to the stipulated number of shares of the Hawley stock as provided by the contract with Hawley. In that and the following year respondent, by the exercise of his option, acquired from Western large amounts of the stock on payment of the option price.

The Tax Court found that at the date of the option the market price of the stock did not exceed the option price, but that in 1938 the market value of the stock then acquired by respondent exceeded its option price by $81,021, and the value of that acquired in 1939 exceeded the option price by $71,663. The court found from the option itself, the resolution of Western's Board of Directors, and from petitioner's own testimony, that "Western gave the option to petitioner [respondent here] as compensation for services rendered in effecting the reorganization plan of Hawley." It held that the excess of the market value of the shares over the option price in the years when the shares were received by respondent, was compensation for his services, taxable as income in those years.

Since the Tax Court found that the market price of the stock on the date of the option did not exceed the option price, it is evident that its finding that the option was given as compensation for respondent's services, had reference to the compensation to be derived from exercise of the option after the anticipated advance in market price of the stock. The option could be exercised only ing at the end of the first sentence on page 2 of the opinion: "Respondent testified that if the option could have been sold at the time he received it, it would have been for only a 'negligible' or 'nominal' amount. He has never contended that the option itself had value when given and there was no finding by The Tax Court that it then had value. The Tax Court, in stating the principle which it deemed applicable to the present case, quoted from Estate of Edward J. Connolly, 45 B. T. A. 374, as follows: 'If the options had never been exercised the optionees would never have received any additional compensation'."

Treasury Regulations 103, Art. 19.22(a)-1.

Section 22(a) of the Revenue Act defines "gross income" subject to the Act as including "gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid. . . ." Treasury Regulations 101, Art. 22(a)-1 provides: "If property is transferred . . . by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such . . . employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered. . . ."

Section 22(a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected. *See Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716, 729. The regulation specifically includes in income, property "transferred . . . by an employer to an employee, for an amount substantially less than its fair market value," even though the transfer takes the form of a sale or exchange, to the extent that the employee receives compensation.

In certain aspects an option may be spoken of as "property" in the hands of the option holder. Cf. *Helvering* v. *San Joaquin*

Fruit and Investment Co., 297 U. S. 496, 498; *Shuster* v. *Helvering*, 121 F. 2d 643, 645. When the option price is less than the market price of the property for the purchase of which the option is given, it may have present value and may be found to be itself compensation for services rendered. But it is plain that in the circumstances of the present case, the option when given did not operate to transfer any of the shares of stock from the employer to the employee within the meaning of § 22(a) and Art. 22(a)-1. Cf. *Palmer* v. *Commissioner*, 302 U. S. 63, 71. And as the option was not found to have any market value when given, it could not itself operate to compensate respondent. It could do so only as it might be the means of securing the transfer of the shares of stock from the employer to the employee at a price less than their market value, or possibly, which we do not decide, as the option might be sold when that disparity in value existed. Hence the compensation for respondent's services, which the parties contemplated, plainly was not confined to the mere delivery to respondent of an option of no present value, but included the compensation obtainable by the exercise of the option given for that purpose. It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation.

The Tax Court thus found that the option was given to respondent as compensation for services, and implicitly that the compensation referred to was the excess in value of the shares of stock over the option price whenever the option was exercised. From these facts it concluded that the compensation was taxable as such by the provisions of the applicable Revenue Acts and regulations. We find no basis for disturbing its findings, and we conclude it correctly applied the law to the facts found. Its decision is affirmed, and the judgment of the Court of Appeals below, reversing it, is

Reversed.

Mr. Justice ROBERTS is of opinion that the judgment should be affirmed for the reasons stated by the Circuit Court of Appeals, 142 F. 2d 818.

SUPREME COURT OF THE UNITED STATES.

No. 371.—October Term, 1944.

Commissioner of Internal Revenue, Petitioner, *vs.* John H. Smith	On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

[April 9, 1945.]

Mr. Chief Justice Stone delivered the opinion of the Court.

Respondent, on motion for rehearing in this Court, for the first time contends that if he is taxable at all after the receipt of the option in 1934, he is taxable as of the date in March, 1938, when he exercised his option, and not when he received the stock in later years. The only later year in question is 1939 in which he received a substantial part of the stock. Before the delivery in 1939 and after the exercise of the option in 1938 there was a substantial increase in the value of the stock. He argues that the tax should be measured by the value of the stock in 1938 less the option price. Cf. *Palmer* v. *Commissioner*, 302 U. S. 63, 73.

It is true that respondent gave notice of his exercise of the option and paid the option price in 1938. But at that time Western, under its contract with Hawley, had a right to receive but a part of the stock subject to respondent's option; its right to the remainder was conditioned upon its making further payments of Hawley's indebtedness. Respondent's option contemplated delivery to him of Hawley's stock only if and when Western became entitled to receive the stock from Hawley. In fact deliveries of the stock were made to respondent upon each occasion only a day or two after Western received it from Hawley.

The Tax Court [illegible] and that respondent received compensation "when [he] exercised his option and received the stock." We take it that the Tax Court regarded fulfillment of the conditions upon the right of Western to receive the stock, and therefore of the conditions upon the derivative right of respondent to receive it under his option, as prerequisite to the effective exercise of the option; and that the taxable compensation to petitioner intended to be secured by the option was in fact received by respondent as

and when the shares of stock were delivered to him, since prior to that time there was no certainty that he would receive the stock. This conclusion of the Tax Court finds ample support in the record, and we concur in it.

We do not have before us a case where by the exercise of an option in one year the taxpayer acquires an unconditional right to receive the stock in a later year. We express no opinion upon the question whether, in such a case, compensation would be received and would be taxable in the earlier or the later year.

The petition for rehearing is denied.

Mr. Justice ROBERTS adheres to his dissent.